Bank of Albania

FINANCIAL STABILITY REPORT

2017/HI

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INTRODUCTION

This is the eighteenth issue of Bank of Albania's Financial Stability Report, which is published half-yearly. The purpose of this Report is to identify and assess risks to the financial system and its infrastructure, in order to provide the public authorities with the possibility to identify the relevant measures for adjustments, as necessary. The Financial Stability Statement, whose half-yearly release is a legal requirement, prefaces the Report.

In producing this Report, we have used data available at the Bank of Albania, and information from other authorities supervising the financial market. We have also used information and analyses by public and private, national and international financial institutions. The data and analyses cover mainly the developments over the first half of 2017 (hereinafter "the period"). Unless otherwise stated, the expectations for the economic and financial outlook extend through a period of up to 12 months

The financial system stability has been assessed based on the performance and risks arising from its interaction with the overall internal and external economic environment, as well as from its activity. In order to assess the risks arising from its interaction with the surrounding environment, this report analyses the latest highlights in international financial markets, and in advanced and regional economies. We have also assessed their impact on the financial system and the banking sector in Albania. Concerning the domestic indicators, this report assesses the overall developments and expectations for economic growth, balance of trade, overall price level, exchange rate and fiscal indicators. Also, by analysing the performance of employment, income, and specific surveys, it evaluates enterprises and households' financial situation, and the impact on the solvency of the banking sector borrowers.

The report presents briefly the results of the stress test, which includes liquidity stress scenarios.

NOTES

As at end-June 2017, banks operating in Albania are divided into the following peer groups by their share:

- Peer Group 1 (each bank sharing 0-2% of total banking sector assets): United Bank of Albania (UBA) sh.a., Veneto Bank (VB) sh.a., International Commercial Bank (ICB) sh.a., First Investment Bank, Albania (FIB) sh.a., Credit Bank of Albania (CBA) sh.a.
  They account for around 4.7% of the sector's total assets.

- Peer Group 2 (each bank sharing 2-7% of total banking sector assets): Procredit Bank (PCB) sh.a., National Bank of Greece-Albania (NBG) sh.a., Societe Generale – Albania (SGA) sh.a., Alfa Bank – Albania (ABA) sh.a., Union Bank (UB) sh.a., Tirana Bank (TB) sh.a., American Bank of Investments (ABI) sh.a.
  They account for around 27.2% of the sector's total assets.

- Peer Group 3 (each bank sharing over 7% of total banking assets): National Commercial Bank (NCB) sh.a., Raiffeisen Bank (RB) sh.a., Credins Bank (CB) sh.a., Intesa Sanpaolo Bank –Albania (ISBA) sh.a.
  They account for around 68.4% of the sector's total assets.

As at end-June 2017, by capital origin, the banks operating in Albania were divided as follows:

- Banks with foreign capital[1]: Raiffeisen Bank sh.a.(Austria); Intesa Sanpaolo Bank – Albania sh.a., Veneto Bank sh.a. (Italy); Alpha Bank – Albania sh.a., Tirana Bank sh.a., National Bank of Greece-Albania sh.a. (Greece); National Commercial Bank sh.a. (Turkey); Société Générale Albania sh.a. (France); ProCredit Bank sh.a. (Germany); First Investment Bank sh.a. (Bulgaria); International Commercial Bank sh.a. (Malaysia); United Bank of Albania sh.a. (Islamic Development Bank – Saudi Arabia); Credit Bank of Albania sh.a. (Kuwait).
  They account for around 82.6% of the sector's total assets.

- Banks with Albanian capital: Credins Bank sh.a., Union Bank sh.a., American Bank of Investments sh.a.
  They account for around 17.4% of the sector's total assets.

As at the end of June 2017, the National Commercial Bank has a branch abroad, in Kosovo.

[1] *By capital origin, when foreign capital accounts for more than 50% of the bank's paid-in capital*

FINANCIAL STABILITY STATEMENT FOR 2017 H1

Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18 December 2006 "On banks in the Republic of Albania", as amended, to inform the Assembly of the Republic of Albania and the Council of Ministers, and draw the attention of financial institutions and of the public on the Albanian financial system situation and the potential risks that may jeopardise its stability, the Bank of Albania releases this periodic statement. This statement is an integral part of the Financial Stability Report for the same stated period.

The Financial Stability Report and the Statement prefacing it assess the exposure of the banking sector to risks arising from its interaction with the external and internal economic environment, real economy agents, financial markets in Albania, as well as operational risks in the activity of the banking sector. In addition, these risks face the financial situation of the banking sector and are stressed through stress test exercises to assess the banking sector's resilience.

The Bank of Albania deems that the activity of the banking sector and of the overall financial system was stable in 2017 H1 and its resilience to activity risks is good.

Overall, the performance of macroeconomic indicators and developments in the economic environment at large provided better support for the activity of the financial system. In the banking sector, indicators of the financial performance, capitalisation and liquidity of the activity, improved overall. However, the analysis of determinant factors and stress test exercises suggest the need for on-going monitoring of their performance over time. Developments in the banking sector during the period showed a significant improvement of the credit quality and affirmed the importance for the continuation of such process.

HIGHLIGHTS IN THE ECONOMIC AND FINANCIAL ENVIRONMENT

Overall, developments in the ***global economy*** were positive in 2017 H1. Economic growth accelerated, driven mainly by favourable financing conditions and continuation of stimulating policies, both in the advanced and in some of the emerging economies. The stable oil prices have contributed to dampening the adverse effects on exporting countries from the earlier price fall. In the euro area, a larger number of member states experienced growth, driven by the growth in private consumption, benefiting from the improvements in labour market

conditions, income growth and stable crediting, especially for households. In the European banking sector, the need for reducing non-performing loans remains high, despite the progress made in this regard. Inflationary pressures remain overall below central bank targets. The developments in the Western Balkans have been similar to those in the global economy. During the period, the countries in this region experienced faster growth, mainly attributable to domestic demand following the downward movement of the unemployment rate. Lending continues to be overall weak mainly concentrated in the households segment, despite the accommodative monetary conditions and the gradual improvement of the asset quality. As a result, the inflationary pressures during the period were contained. In line with stimulating financial policies and other economic reforms, the International Monetary Fund (IMF) projects the global output to grow by 3.5% - 3.6% in 2017-2018, with positive contribution from both advanced and emerging economies. The normalisation of the monetary policy in advanced economies and the possibility of added market volatility are currently the main risks for the global economy perspective.

In Albania, the annual pace of economic growth rose to 3.94% at the end of the first quarter. Services, manufacturing and agriculture contributed to economic growth, especially the branches of trade, construction, transport and industry. The growth in aggregate demand was supported by the expansion of the final consumption of the population (with the main share), growth in government consumption and fixed capital formation. Moreover, the narrowing of the current account deficit in the balance of payments contributed also positively to the expansion of demand, mainly due to the expansion of the positive balance in the services account. In the labour market, the unemployment rate stood at 14.2%, almost unchanged from the end of 2016 and 2.4 percentage points lower than in the first quarter of the previous year. During the period, following subdued inflationary pressures, the monetary policy continued to be accommodative, underpinning the expansion of economic activity. The positive budget balance reflected the continuation of the fiscal consolidation process. But, the value of the budget surplus was lower than in the same period a year earlier, as a result of faster realisation of expenditures than the collection of revenues.

In the domestic financial market, during the period, the average yield on investments in government debt securities rose slightly. The short-term debt securities contributed most to this performance. For these securities, the level and the increase in issues were higher than for the long-term debt securities. The participation of investors in government debt securities auctions has been steady, and their preference is higher for longer-term maturities. In the interbank market, banks have traded overall low volumes at rates constantly below or close to the policy rate level, thus reflecting a stable liquidity situation. In the foreign exchange market, the Albanian lek appreciated against the euro and the US dollar. This performance reflected the more positive developments in the balance of payments with foreign countries. In the real estate market, data and surveys point to a fall in house prices, mainly following the increase in housing

capacities. In this market, the operators' expectations for the performance of the real estate prices remain positive.

During the period, the creditor position[2] of **households** and the debtor position of **enterprises** decreased. For households, the effect came from the increase in lek credit and decrease in deposits, mainly in foreign currency; for enterprises, the effect came from the faster decrease in foreign currency credit than the decrease in deposits. Credit to households grew 2.8% during the period. Growth owes almost entirely to the growth in lek credit for residents. Credit to enterprises contracted during the period by 2.3%; the main contribution came from resident entities, whereas credit to non-residents grew. The credit quality improved for both households and businesses. During the period, the values of outstanding credit and deposits of entities with the banking sector were significantly affected, on the downside, by the appreciation of the Albanian lek against the major currencies.

The share of the activity of the ***financial system*** in the Gross Domestic Product (GDP) is estimated to have decreased to 101.9% at the end of the period, but the main financial indicators were overall improved. The decrease in the share of the financial system was driven mainly by the decrease in the share of the banking activity, which fell to 91.9% of the GDP. The non-banking sector retained its share in the GDP, and non-bank financial institutions, private pension funds and investment funds made positive contribution to its activity. In the activity of the banking sector, which contracted by 1% over the period, on the assets side of the balance sheet, the largest change was noted in transactions with securities, mainly with non-residents (down), transactions with the treasury (down) and interbank transactions, mainly in the form of deposits with non-resident entities (up). On the liabilities side, the largest change was noted in client deposits (down) and capital (up). From a year earlier, the activity of the banking sector increased by 4.8%, with deposits growing by 3.5%, outstanding credit remained unchanged and net creditor position with non-residents increased by 11.7%. The outstanding credit reflects the write off of loss loans from the balance sheets of the banking sector, and a still sluggish credit demand, as reflected in the relevant surveys of the financial situation of households and enterprises. The direct exposure of the banking sector to in the non-banking sector is estimated as low, whereas the banking sector stability remains a critical factor for the activity and stability of the non-banking sector.

BANKING SECTOR'S EXPOSURE TO ACTIVITY RISKS

The Bank of Albania assesses the activity risks that the banking sector is faced with, as follows:

a) *Credit risk fell significantly during the period as well as against the*

[2] *The spread between deposits and credit to households in the banking sector.*

same period in the previous year. Non-performing loans fell by 15.2% during the period and by 22% from the previous year. As a result, the ratio of non-performing loans fell by 2.7 percentage points during the period, to 15.6%. Banks actions to collect, restructure, and write them off from the balance sheet contributed to the reduction of the non-performing loans. Non-performing loans were also reduced across all the constituting categories, with each recording a decrease in the value. Among the existing non-performing loans, the lowest quality is noted in the foreign currency credit, credit to enterprises and credit with longer-term maturity. The reduction of non-performing loans is accompanied by the improvement of their coverage with reserve funds (provisions) and capital, while the level of credit collateralisation improved slightly.

The reduction of non-performing loans during the period is a notably positive development, which will release resources of banks engaged in the management of non-performing loans, gradually improve the perception of the banking sector on the credit risk, and eventually give a stronger boost to credit growth in the period ahead. In the process of resolving the non-performing loans, banks appear more active with regard to early restructuring. As a result, this will better contribute not only to reducing the stock of non-performing loans, but also to keeping their new flows under control. Moreover, the process will be useful for identifying financially-valid projects faster, thus allowing banks to act quicker on collecting a loan from a poor-performing borrower. On the other hand, the process should be carried out in a prudent and professional manner, in order for the restructuring to be effective, the chances for improving the borrower's repayment capacity to be real and incentives for a regular credit repayment to remain strong. Regardless of the significant improvement, the level of non-performing loans in the banking sector is estimated as still high. This situation requires the banks to be fully and constantly engaged in this process.

b) *Liquidity risk in the banking activity is considered as low*. The liquidity ratios, both in lek and foreign currency, stand significantly above the minimum regulatory requirements. Deposits are the main source of financing, covering almost double the volume of the sector's credit. Reliance on foreign credit lines is very low.

Yet, the negative gap between assets and liabilities by segment of residual maturity, vis-à-vis the total assets in the short term, is considered as high and has increased against previous periods. The change in the structure of liabilities, in which the share of time deposits continues to lessen against other non-term alternatives, contributes to maintaining this gap. Such structure of liabilities imposes the need for the banking sector to maintain high level of liquid assets, and seek higher return through longer-term investments. This feature is related to the actual stage of the financial cycle and should gradually change at a time

when macroeconomic developments require an increase in interest rates, which leads to higher opportune cost of the public for maintaining their savings in more liquid forms.

c) *The banking sector's exposure to market risks remains important.* The banking sector's net open position in foreign exchange to regulatory capital ranged within long-term levels, pointing to a limited and downward exposure of the banking sector to the direct impact on the balance sheet, from the exchange rate volatility. During the period, the unhedged foreign currency credit remained stable in terms of both total credit and foreign currency credit. At the same time, its quality improved. Overall, these developments show that, during the period, the banking sector has controlled the direct and indirect exposure to exchange rate fluctuations; however, the exposure is assessed to be still high and actions need to be taken more actively for reducing it further. The Bank of Albania believes that the measures proposed in the framework of the strategy for reducing the usage level of foreign currencies in the Albanian financial system and economy, will contribute toward achieving this objective. These measures have been discussed with the banking industry and work has started for preparing the necessary regulatory acts.

About the impact of movements in the interest rate, the banking sector remains exposed to fluctuations in the interest rate, at a time when the gap between assets and liabilities, sensitive to interest rate according to re-pricing periods, is relatively high. The current environment with relatively low interest rates suggests the need for the banking sector and other non-bank financial institutions, such as life insurance companies, private supplementary pension funds and investments funds, to evaluate regularly direct and indirect implications, which could result on their activity from unfavourable movements in the interest rates.

d) *Some of the European banking groups that operate in Albania are still undergoing a restructuring process for improving their financial situation.* This process includes operations such as: restructuring the network, change of shareholders and merging with other institutions. Developments in the European legislation regarding the recovery and resolution of banks have rendered these processes more effective and unfelt for the banks' clients. At the same time, such legal definitions and operational actions highlight the importance of coordination between relevant authorities in the countries where the banking group under restructuring operates. In this regard, the Bank of Albania remains committed to monitoring the developments and coordinate potentially necessary actions with the relevant domestic and foreign authorities, in order to achieve the ultimate objective of safeguarding the stability of the financial system.

RISKS TO FINANCIAL STABILITY

To assess systemic risks, the performance of indicators related to the materialization and accumulation of the systemic risk is analysed against the stress level in the financial system and the perception of the banking industry regarding its activities' exposure to systemic risks. Also, the financial stability map provides a consolidated approach of risk assessment to financial stability.

Indices for the materialisation and accumulation of systemic risks show that risks to financial stability have fallen during the period. The improvement of economic growth, positive developments in the labour market, narrowing of the current account deficit in the balance of payments, continuation of the fiscal consolidation and decrease in the level of debt to enterprises, have contributed positively to the macroeconomic framework; the reduction in non-performing loans, improvement of the financial performance and good capitalisation and liquidity levels have contributed positively to the performance of the banking sector. Surveys show also that the perception of systemic risks by the banking sector is at lower levels, mainly due to the acceleration of economic growth and improvement of the credit quality. Nevertheless, the banks sensitivity about remaining uncertainties that surround the collateral execution process remains considerable.

BANKING SECTOR'S ABILITY TO WITHSTAND RISKS

The banking sector's ability to withstand risks is assessed by analysing its capitalization and profitability situation, and by testing the adequacy of these indicators through stress-test scenarios.

At the end of the period, the banking sector's capital adequacy ratio was 16.3%, around 0.3 percentage point higher than at the end of 2016, and notably higher than the 12% level of the minimum requirement. The financial result of the sector improved during the period. The profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.6% and 16.7%, standing 0.9 percentage point and 8.7 percentage points, respectively, higher than in the same period in the previous year. However, the positive contribution to the financial sector's performance has come from the decline in credit risk provisions, reiterating the sensitivity of the banking sector to the continuation of this process. Meanwhile, the financial result from the core activity of financial intermediation, as reflected in net interest income continued to decrease. The net interest income decreased due to return on investments falling faster than the relevant expenditures, against the backdrop of operating in an environment of low interest rates for a relatively long period of time. On the other hand, the improvement in the capital adequacy ratio reflects the contraction in risk-weighted assets, as a result of the subdued credit activity and regulatory amendments regarding investments in non-resident financial

institutions. Under these conditions, the very good levels of the above-stated ratios may show a higher volatility in the future and their stability over time should be carefully assessed.

The adequacy of the above indicators was assessed during stress tests, with scenarios that assumed adverse changes in macroeconomic and financial indicators for the period 2017-2018. Similar to before, among extreme assumptions with a low probability of occurrence, the adverse scenario included the contraction of the economy, contraction of credit, rapid growth of interest rates and strong depreciation of the exchange rate. The results of the stress test show that in the baseline and the moderate scenarios, the banking sector remains capitalized, whilst in the adverse scenario it would need to raise the level of capital.

Based on this analysis, the Bank of Albania deems that capitalization and profitability of banks is actually adequate to withstand the activity risks. But their performance needs to be monitored continuously by the banks, and actions need to be taken to ensure the stability of the indicators at adequate levels for supporting their activity.

The next chapters will present in greater detail the report on financial stability for the first half of 2017.

1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

The Financial Stability Map shows the allocation of risk among factors that determine the stability of the financial system, which include the activity of the banking sector, the surrounding external and internal environment, and the real economy agents: government, enterprises and households.

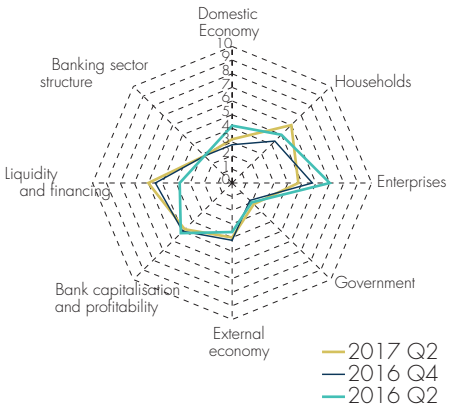
(1) As at end of 2017 H1 (hereinafter referred as "the period"), compared to the previous year, ***the financial stability map shows, overall, a decrease of risks in the external and internal environment, and identifies different developments in risks of the banking sector and of the real economy agents.*** The decrease of risks in the overall economic environment mainly reflects the higher economic growth rates and the overall macroeconomic stability. Their different exposure against risk in other factors reflects their peculiarities regarding the financial performance, the financing structure as well as the debt performance and level.

(2) In more concrete terms,

- In the overall economic environment:
  - Risk from "the domestic economy" is assessed as "low", following the improvement in the narrowing of the output gap; the fall in the size of the external debt; and the level of external financing requirement;
  - Risk from the "external economic environment" is assessed as "low" and downward over the period, mainly driven by the positive economic performance of our trading partners and an environment with low financing rates.

- Real economy agents:
  - Risk from "households", is assessed as "moderate" and upward attributable to developments in the housing market and lower households' expectations;
  - Risk from "enterprises", is assessed as "average" and downward, given the improved quality of the loan portfolio to this category, developments in the production volume index and the upward expectation of the private sector;
  - For the "government", risk continued to be assessed as "low" and unchanged during the period under review, based on the stability of sovereign risk premia, low level of debt cost and the better performance of tax revenues.

Chart 1.1 Financial stability map



*Risk is rated: low for scores 0-3 in the map, average for scores 4-5,moderate for scores 6-8 and high for scores 9-10. The farther from the center, the higher the risk.

Source: Bank of Albania, Financial Stability Department.

o While in the banking sector activity:

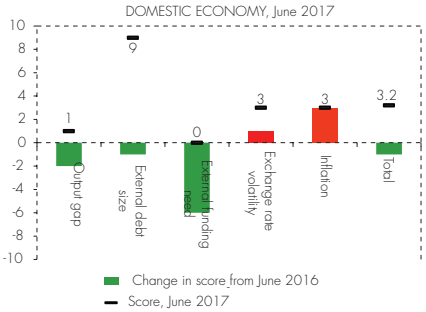
- Risk from "capitalisation and profitability", is assessed as "average" and unchanged during the period. Capitalisation level and loan quality improved, contributing to the decrease of risk from this category, while income from interests provided a downward contribution to the overall level of profitability;
- Risk form "liquidity and financing" is assessed as "moderate" and again upward, reflecting the deepening of the banks' assets and liabilities mismatch up to three months[3], and a lower growth of households' deposits. The continuation of the fall in the values of liquidity indicators, signals an improvement of intermediation by the banking sector and a higher commitment in orienting the financial sources toward lending to the economy. In the long run, the more effective allocation of banking sector's financial sources is expected to further support the economic activity at home, and to affect positively the capitalisation and the financial performance of the banking sector;
- Lastly, the risk related to "banking sector structure" continues to be assessed as "low", supported by a better diversification of financing funds and the improved allocation of credit in the banking sector, somewhat offsetting the risk from the still high credit concentration in the "enterprises" segment.

[3] *Within this category, which overall is assessed with low risk, this is a result of the change in the definition of the proper term, for purposes of more detailed analyses by the supervisory authority.*

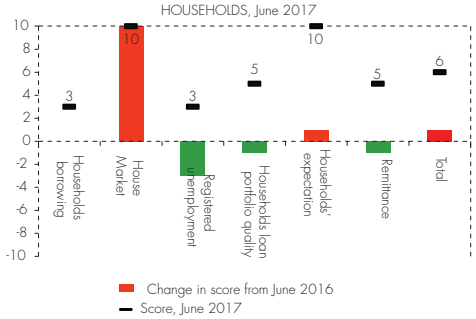
Box 1.1 shows the Financial Stability Map components over 2017 H1, the score for each risk level and comparison with the scores in the previous year.

BOX 1.1 FINANCIAL STABILITY MAP COMPONENTS

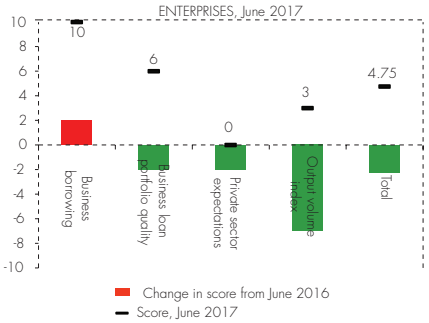
Risk from "domestic economy" is rated as "low" and downward, following the improvement of output gap, size of external debt and needs for external financing.



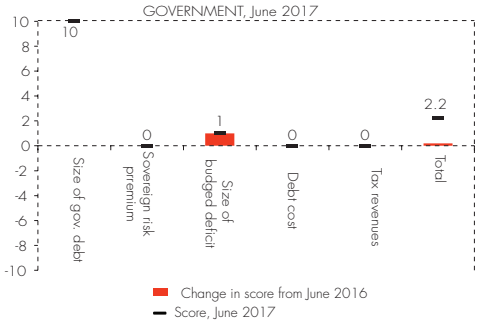
Risk to "households" is rated as "moderate" and upward, due to the fall of households' expectations and developments in the housing market.



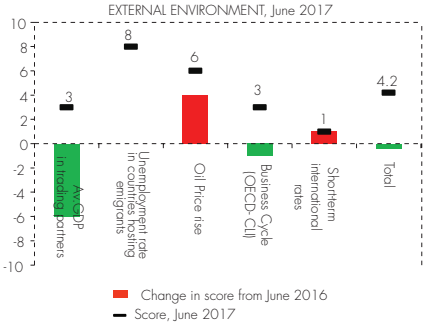
Risk to "enterprises" rated as "average" and downward, reflecting the improvement in the credit quality, enterprises' expectations and production volume index.



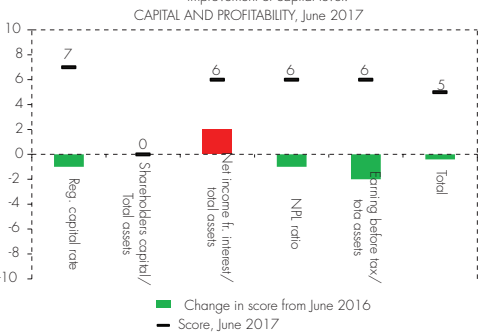
Risk from "Government" rated as "low" and unchanged, based on the sovereign risk premia, debt cost and the performance of tax revenues.



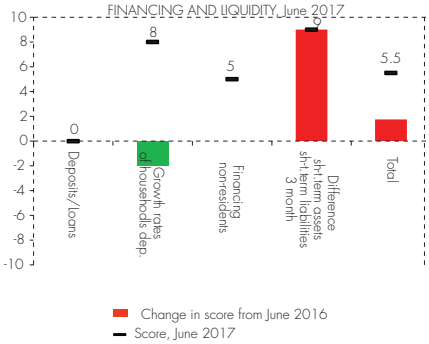
Risk from "external environment" rated as "low" and downward compared with June 2016, affected by the improved economic growth of trading partners and the performance of total CLI index. The increase in oil prices and the performance of international short-term rates contributed in the increase of this risk.



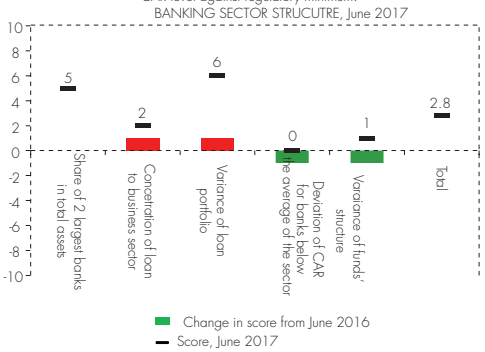
Risk from "capital and profitability" rated as "low" and unchanged, over the period. The increase of risk from the fall of interest income is offset from the improvement of other indicators, such as the fall of NPLs and the improvement of capital level.



Risk from "financing and liquidity" resulted again "moderate" and upward during the period, due to the deepening of the gap between short-term, up to three months, assets and liabilities.



Risk related to the "banking sector structure" continued to be low and unchanged, given the increase in the diversification of its financing funds and CAR level against regulatory minimum.



Source: Bank of Albania, Financial Stability Department.

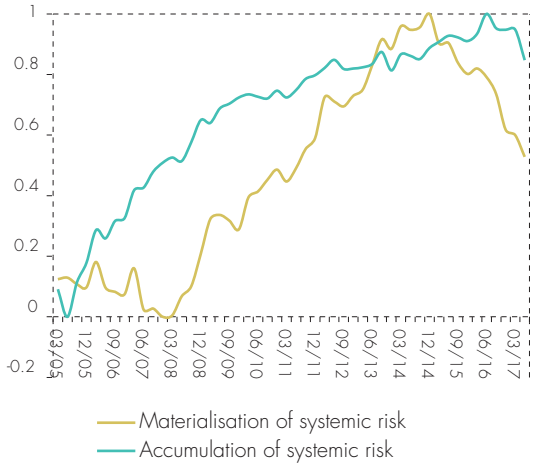
1.1 SYSTEMIC RISK[4]

To assess the banking sector's exposure to systemic risk, the performance of indicators related to: a) the materialization and accumulation of the systemic risk; b) the stress level in the financial system; c) the perception of the banking industry regarding the exposure to systemic risks, is analysed. The materialisation of the systemic risk assesses the actual level of the risk, whilst indices of the risk accumulation, financial stress, and the banking industry perception on it, focus mainly toward the future.

(3) Materialisation of systemic risk has been downward over the period and compared with the previous year. The improved credit quality to households and enterprises, the decline in the unemployment rate at home, and the diminishing exchange rate volatility have contributed to the performance of this index (see Chart 1.2.).

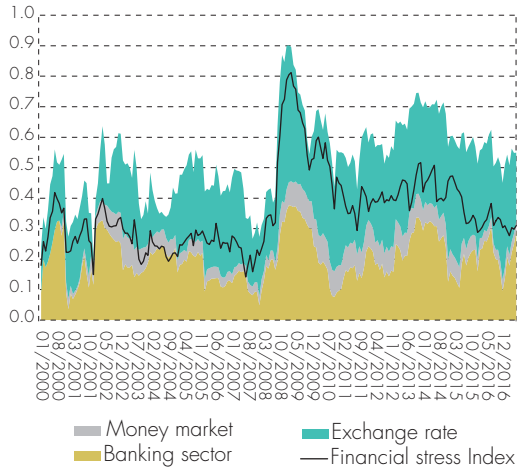
(4) Accumulation of systemic risk and financial stress index also were downward. The reduction of enterprises' debt, the decrease of public debt and the narrowing of the current account deficit provided the main contribution to the decrease of risk accumulation. Financial stress index was down. The further decrease of depreciating pressures of the domestic currency and the developments in interbank market also contributed to this fall (see Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk



Source: Bank of Albania, Financial Stability Department.

Chart 1.3. Financial Stress Index



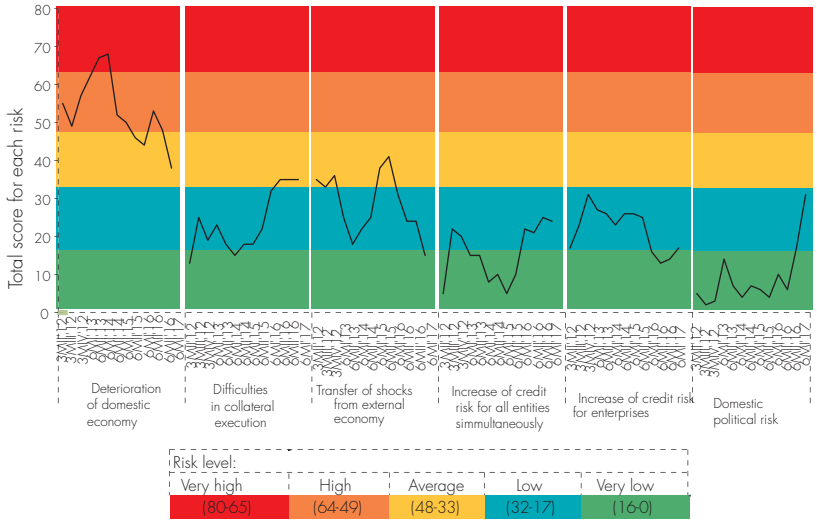
Source: Bank of Albania, Financial Stability Department.

(5) Banks' perception shows a more positive assessment of systemic risks performance over the period. Hence, the potential risk from "Deterioration of the domestic economy", albeit continuing to be considered as the main systemic risk at home, is perceived considerably lower due to higher economic

[4] *Systemic risk is defined as "the possibility for the materialization of shocks that impair the functioning of a financial system to the point where economic growth and welfare suffer materially".*

growth in Albania. Risk perception from the "difficulties in the execution of collaterals" remains relatively high and has been unchanged over the period. Unlike in the previous period, in 2017 H1, banking sector's sensitivity against "political risk at home" increased, mainly driven by the temporary uncertainty on the eve of June 2017 general elections. Risks related to the credit process continue to be classified as the most important systemic risks, given that the non-performing loans portfolio, though considerably improved, remains high. Finally, the banks' assessment regarding risk from "external shocks" has trended downward, since a year earlier (see Chart 1.4).

Chart 1.4 Banks' assessment of main systemic risks



Source: Bank of Albania, Financial Stability Department.

2. INTERNATIONAL DEVELOPMENTS

(6) During the period, global economic developments were generally positive. The economy grew faster in the second quarter, mainly driven by the favourable financing conditions and the continuation of accommodative policies in advanced countries and in some emerging countries. At the end of the previous year, oil prices recovered somewhat, helping thus the exporting economies, but this performance was short lived, and prices returned to the previous levels. Conditions in financial markets, overall, were favourable, notwithstanding the deepening of divergences among the monetary policies of advanced countries. The European Central Bank (ECB) and the other larger banks continued to implement accommodative monetary policies, while the Federal Reserve further tightened its monetary policy. The global inflationary pressures remained subdued, owing to oil and primary commodity prices. Inflation rates in advanced economies returned at rates below central bank targets, while in emerging countries they were stable or downward. Based on these developments, the IMF's outlook for global growth is 3.5% in 2017 and 3.6% in 2018[5], positively affected by the performance in both advanced and emerging economies.

(7) Economic growth accelerated in advanced economies, and maintained the positive trend in emerging economies. Among *advanced economies*, the US economy revved up over 2017 Q2, after a weaker start to the year. The surge was mainly fuelled by the positive contribution of consumer spending and inventories. Conditions in the labour market continued to improve and the unemployment rate fell at 4.4%. In the United Kingdom, economic activity slowed down during this year, due to the fall in private consumption, as a result of the depreciation of the British pound and the increase of inflation. Economic performance, across *emerging markets*, overall, was positive. Nevertheless, differences across countries remain notable, owing to a set of internal and external factors. Hence, the stimulating fiscal policies continued to support the stable economic performance in China, while oil price recovery, at the end of the previous year, and the positive expectations about the global trade, have supported the exporting economies.

(8) Economic growth of the euro area is more balanced. Most countries in this region recorded positive growth, mainly driven by the domestic demand, and partially by the positive contribution of inventories. Labour market conditions continued to improve, underpinning the increase in households' income and consumption. Employment increased close to the level of the pre-crisis period, while unemployment fell at 9.1%.

[5] *IMF: World Economic Outlook, July 2017.*

(9) In the euro area banking sector, lending, overall, grew driven by lending to households. The continuous easing of lending standards and the low financing costs boosted the credit supply and demand in most euro area countries. On the other hand, notwithstanding the notable progress of some European banks in clearing and consolidating their balance sheets, the still high level of non-performing loans continues to decelerate the credit recovery.

(10) Global economic growth is expected to continue in the period 2017-2018. Emerging regions will have the main share in this growth. Their economies are expected to further improve in the two next years. Advanced economies, also, will continue to recover, but at a subdued pace during the next year. The normalisation of monetary policy in advanced countries, and the response of relevant markets are currently the main risks to the global economy perspective. On the other hand, risks related to low inflationary pressures, macroeconomic structural weaknesses in emerging economies or the yet-to-be completed balance sheet consolidation of financial institutions in advanced economies continue to be present in the global macroeconomic environment.

(11) In the euro area, monetary policy pass-through to the real economy will continue to underpin the increase of domestic demand and ease the consolidation of both private and public sectors' balance sheets. The favourable financing conditions and the increase of profitability in the private sector will promote the further growth of investments, while global economy recovery is expected to favour European exports. The improvement of labour market conditions will continue to contribute positively to the growth of private consumption, through the increase in household disposable income. Main risks to expectations for the euro area's economic performance are mainly related to external factors, such as the policies of the US administration, and the new relationship with the United Kingdom after "Brexit". Nevertheless, in some countries of the region, internal risks remain, such as the protraction of structural reforms and the slow progress in consolidating the balance sheets in certain sectors.

Table 2.1 Selected macroeconomic indicators for the U.S. and euro area

	GDP change (annual %)				Inflation (annual %)		Unemployment (annual %)		Gross government debt (as a % of GDP)	
	2017 Q1	2017 Q2	2017f	2018f	March 2017	June 2017	March 2017	June 2017	2016 Q4	2017 Q1
U.S.	1.2	2.6	2.1	2.1	2.4	1.6	4.5	4.4	105.7	104.1
Euro area	1.9	2.1	1.9	1.7	1.5	1.3	9.4	9.1	89.2	89.5
- Germany	1.7	:	1.8	1.6	1.5	1.5	3.9	3.8	68.3	66.9
-France	1.0	:	1.5	1.7	1.4	0.8	9.6	9.6	96.3	98.7
-Italy	1.2	:	1.3	1.0	1.4	1.2	11.5	11.1	132.6	134.7
-Greece	0.4	:	:	:	1.7	0.9	22.0	:	179.0	176.2

Source: European central Bank, Eurostat, BEA (Bureau of Economic Analysis), Bureau of Labour Statistics, IMF; f-IMF estimates, July 2017; no available data.

(12) Economic growth in Western Balkans was satisfactory at the end of 2016, in particular in Serbia and Albania, albeit the pace was somewhat moderate in 2017 Q1. Economic activity in the region and Turkey expanded

by 2.8% (annual growth) in 2016 Q4, but it slowed down at 1.8% in 2017 Q1. All regional countries, excluding Macedonia, recorded a positive growth during 2017 Q1, mainly driven by private consumption and investments. Nevertheless, except Kosovo, where growth exceeded expectations, economic activity in other regional countries slowed down. Turkey also recorded accelerated growth, mainly driven by trade and the growth of public expenditure, due to the efforts of the government to support the economy of the country. Notwithstanding the specific problems, labour market conditions continued to improve, reflected in the increase of employment and decrease of unemployment. Low inflationary pressures continue to characterise Western Balkans, by reflecting the low prices in primary commodities and the stability of the exchange rate. In the banking sector, lending continued to support economic growth in the region. In all regional countries, credit growth to households was higher than that to enterprises. During 2017 Q1, the major part of the regional countries reduced the non-performing loans portfolio, and improved the framework to address them. Nevertheless, this indicator remains high, thus decelerating credit recovery in the region.

Table 2.2 Selected macroeconomic and financial indicators for Western Balkans

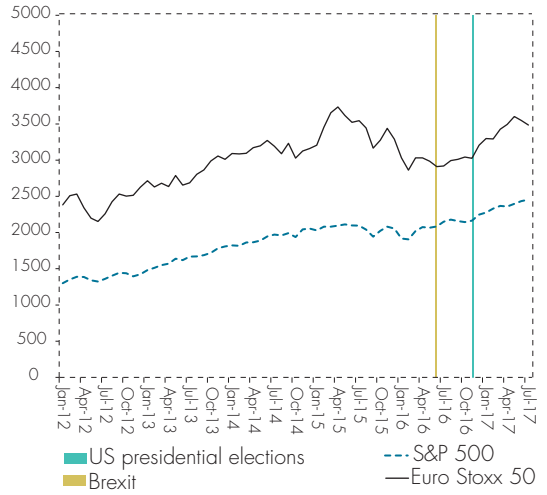
	GDP (real, annual %)			Unemployment (Annual %)		Sovereign debt (% of GDP)		Credit growth (Annual %)		Non-performing loans ratio	
	2016 Q4	2017 Q1	2017f	2016 Q4	2017 Q1	2016 Q4	2017 Q1	2016 Q4	2017 Q1	2016 Q4	2017 Q1
B&H	2.6	:	:	25.4	:	41.4	:	1.8	3.0	11.8	11.5
Macedonia	2.4	0.0	2.9	23.1	22.9	40.9	37.8	1.4	0.1	6.3	6.1
Montenegro	3.4	3.2	3.3	17.9	17.7	62.4	61.6	1.3	5.5	10.3	9.9
Kosovo	3.0	3.8	:	27.5	:	14.5	:	9.9	10.6	4.9	:
Serbia	2.5	1.2	3.2	13.0	14.6	72.8	71.5	9.0	7.6	17.0	16.8

Source: European Commission, ECFIN's forecast, 2017.

2.1 HIGHLIGHTS IN FINANCIAL AND PRIMARY COMMODITY MARKETS

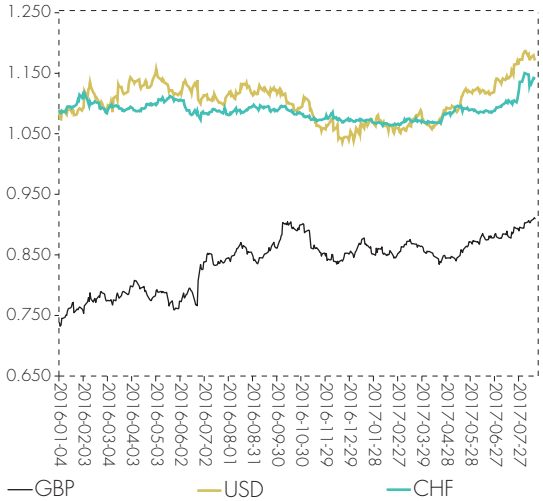
(13) During the period, developments in global financial markets, overall, were favourable and stable. The recent shocks related with the presidential elections in the US and France were rapidly absorbed by markets. The rise in the policy rate by the Federal Reserve in 2017 caused markets to fluctuate, affected by the expectations for gradual monetary tightening, while the other main central banks (ECB, Bank of England and Bank of Japan) are expected to continue the accommodative monetary policy stance. The performance of values and rates in advanced markets were also affected positively by the good economic performance in these countries and the optimistic outlook. Hence, the yields in European and American markets of government debt securities fell and spreads narrowed, particularly in the second quarter, reflecting the fall of investors' perception about this risk. This performance promoted also the increase of prices in equity markets for both financial and non-financial sectors. Money markets continued to be characterised by negative rates and ample liquidity levels, reflecting the monetary policy stance in many advanced economies.

Chart 2.1 Main indices stock market



Source: European Central Bank.

Chart 2.2 Exchange rate - euro versus main currencies



Source: European Central Bank.

(14) Expectations about the future course of monetary policies and differences in the stages of economic cycles across countries imposed the fluctuations of the exchange rate. Hence, overall, during 2017 Q2, the euro appreciated against the currencies of advanced economies, US dollar and Swiss franc, as well as against the currencies of a considerable part of emerging regions.

(15) The recovery of oil prices at the end of the previous year and at the beginning of 2017 appears to have been limited, mainly imposed by supply-side factors. The effects of the agreement between the main oil producers[6] to cut oil production quota, seems to have resulted as temporary, affected by the growth of US inventories. As a result, gross oil prices during March June 2017 ranged from USD 46/barrel to USD 54/ barrel. The extension of the agreement on the cut of oil production quota by nine months seems to have been anticipated by the markets, thus it did not provide the desired effect in the increase of oil price. The prices of other commodities, particularly of metals, have been also falling since March 2017, mainly affected by the fall in the demand from China.

[6] *The agreement (signed in June 2016, and ratified on 30 November 2016) among OPEC and non-OPEC countries sets out the cut of oil production quota by 1.27 and 0.6 million bpd, respectively. On 25 May 2017, this agreement was extended by nine months.*

BOX 2.1 DEVELOPMENTS IN FOREIGN BANKING GROUPS OPERATING IN ALBANIA

At the end of the period, foreign banking groups operating in Albania show stable capitalisation levels, although the financial result in some of them was negative. The following table shows some main indicators of the financial statements of the parent banking groups operating in Albania, in relative terms, compared to the same period in the previous year. Related to the share of the Albanian subsidiaries in the activity of the banking group, the operations performed during the period reflect the specifics of their individual activity.

Table 2.3 Highlights of foreign banking groups operating in Albania

Change (%)	Raiffesen Bank International[1]	Intesa San Paolo[2]	Alpha Bank[3]	Piraeus Bank[4]	National Bank of Greece[5]	Societe Generale[6]
Assets	2.8%	2.3%	-6.0%	-11.0%	-10.5%	-2.3%
Loans	1.7%	1.2%	-3.6%	-3.0%	-3.5%	-1.9%
Deposits	1.6%	-2.7%	6.9%	7.0%	0.8%	-3.5%
Provisions	-81.1%	-75.0%	-3.6%	-6.0%	-67.9%	-6.7%
Net profit	...	...	...	(...)	-59.4%	-24.3%
Operational income	5.0%	-1.0%	0.6%	3.0%	7.6%	-26.1%
Net income from interests	1.3%	-1.8%	1.4%	-2.0%	0.3%	-12.1%
Net income from commissions	8.9%	5.8%	-1.8%	10.0%	...	-
Operational expenditures	2.0%	0%	-7.2%	-4.0%	5.9%	4.4%
Net result	9.4%	-1.9%	-	4.0%	-53.0%	19.9%
Ratios						
NPLs	7.3%	3.8%	38.1%	37.8%	-	4.6%
Net interest margin	2.46%	-	3.0%	2.7%	3.04%	-
Capital adequacy	12.9%	13.0%	17.2%	16.3%	16.0%	14.4%
Bank assets in Albania against total group	1.38%	0.15%	0.81%	0.72%	0.38%	0.05%

Note: (...) shows pronounced change (over 100%), whether in positive or negative terms.
(-) shows data are unavailable in the publications of the respective bank.
Source: Official pages of the banking groups.

During 2017 H1, the activity of the banking group "Veneto Banca" was completely restructured, after a decision of the Bank of Italy and the Italian Government. The major part of this group activity, including its subsidiaries in Albania and in some other countries, was transferred to Intesa Sanpaolo Bank, which is the largest banking group in Italy. This change is confirmed also in the press release by Intesa Sanpaolo banking group of 26 June 2017. For the Albanian banking sector it means that "Banka Veneto" sh.a, previously under complete ownership of "Veneto Banca", now is in ownership of "Intesa Sanpaolo" banking group, and its activity shall be part of this banking group.

Some European banking groups operating in Albania are still undergoing a restructuring process to improve the financial situation. This process includes: network restructuring, change of shareholders or merger with other institutions. Developments in the European legislation in terms of recovery and resolution are insensitive to banks' clients. At the same time, these legal stipulations and the operational actions show the importance of coordinating the actions among the responsible authorities at the countries where the banking group under reconstruction performs its activity. In this regard, the Bank of Albania remains committed to monitor the developments and coordinate the potential necessary actions, with the relevant domestic and international authorities, with the purpose the fulfilment of the final objective to maintain the financial system stability.

3. MACROECONOMIC DEVELOPMENTS IN ALBANIA

(16) In 2017 Q1, economic activity in Albania accelerated its growth pace, at 3.94%. Services, production and agriculture sectors, particularly the branches of trade, construction, transport and industry contributed to growth. The expansion of the final consumption of population (with the highest share), increase of government consumption and the fixed capital formation supported the growth of aggregate demand. Also, the narrowing of the current account deficit in the balance of payments, mainly due to the expansion of the positive surplus in services account, contributed positively to the expansion of demand. The labour market recorded also positive developments. The unemployment rate stood at 14.2%[7]. Expectations for employment in 2017 H2 remain positive for all the sectors of the economy.

(17) During the period, following the contained inflationary pressures, the monetary policy remained accommodative to promote the expansion of economic activity. The stimulating monetary conditions supported crediting, contributing to the recovery of consumption and private investments, aiming at the gradual return of inflation close to the target level. In June 2017, annual inflation stood at 2.2%, upward compared to the same period in the previous year[8]. The steady inflation was mainly affected by the improved economic activity and the upward trend of prices in global markets. The Bank of Albania expects the effect of these factors to expand in the periods ahead, driving inflation values towards the target of 3% in the medium term.

(18) During the period, fiscal consolidation showed a slower pace. At the end of the period, budget surplus was positive, about ALL 3.1 billion, from ALL 17.2 billion in the previous year. The budget surplus narrowed due to the budget expenditures increasing at a higher pace than revenues[9]. Notwithstanding the positive impulse by the narrowed budget surplus in the economic growth in the short run, the fiscal consolidation process should continue to ensure the stability of economic growth in the longer term. An optimum planning of the main budget items and the improvement of the realisation level of capital spending are important to this process.

(19) The overall balance of payments was positive. Foreign assets (reserve) expanded during 2017 Q1. At the end of 2017 Q1, the current account deficit in the balance of payments decreased considerably, shrinking by 20%

[7] *Unemployment rate was 16.6% in 2016 Q1, while it almost remains at the same level in December 2016: 14.17%.*

[8] *In more concrete terms, this rate stood at 2.2% in December, from 1.2% in June 2016.*

[9] *Annual income recorded an accumulative value of ALL 212.2 billion (7.0% annual growth), while general expenditure was ALL 209.2 billion (15.5% annual growth).*

in annual terms, at EUR 179 million. This performance was determined by the positive surplus in the services account[10] and the slower expansion of trade deficit of goods due to the faster increase of exports[11]. The inflows in the secondary income account did not substantially change from the previous year[12]. In this category, remittances share around 80% of the total and are assessed to have provided foreign currency inflows at around EUR 137 million. The narrowing trade deficit in goods was attributable to: (i) increase in the export of mineral products in "Ores, slag and ash" and (ii) increase in the export of "Base metals and their items (cast iron and stainless steel)". The flow of financial liabilities of Albania to the world is assessed at EUR 272 million, recording an annual increase of 2%. Financial liabilities were at the highest level created from foreign direct investments, which stood at EUR 168 million, around 8% higher than in the previous year. Energy and hydrocarbon sectors provided the main contribution to the growth of foreign direct investments. Liabilities in the form of other investments grew around 4% in annual terms, or expanding by EUR 128 million.

[10] *The expansion of surplus in this category was mainly attributable to the growth of income from business, transport and travel services (the latters' balance was EUR 76 million, 12% higher from the previous year). Positive surplus in services account was EUR 274 million, being EUR 98 million higher than in the same period in the previous year.*

[11] *Compared to the same period in the previous year, exports grew by 45%, while imports grew only 9%, standing at EUR 182 and EUR 769 million, respectively*

[12] *Secondary inflows stood at EUR 170 million.*

4. FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND ENTERPRISES

(20) During the period, households remained inclined toward saving, but trending downward, while enterprises narrowed their net debt position. The growth of credit in lek to households and the fall of their deposits, affected the narrowing of their credit position.[13] For the same period, credit to enterprises fell at a higher pace than the fall in deposits, narrowing therefore their debtor[14] position. In annual terms, unlike the half-yearly trend, households show a slight expansion of the creditor position attributable to the creditor position in foreign currency[15]. Meanwhile, enterprises narrowed more considerably their net debtor position attributable to the considerable fall of credit and the expansion of deposits, mainly in foreign currency[16]. The loss loans write off from banks' balance sheets drove to a considerable annual improvement of the entire credit quality, and in particular of the unhedged foreign currency loans.

4.1 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

(21) During the period, the creditor position of households fell at ALL 765.4 billion, affected by the drop of deposits, mainly in foreign currency, and the increase of credit. The orientation of credit to households in the domestic currency contributed to the narrowing of the creditor position in lek at a higher pace than in foreign currency[17]. Also, enterprises narrowed their debtor position against the banking sector, standing at ALL 158.2 billion. The narrowing of the debtor position of enterprises was attributable to the faster contraction of credit compared with the fall of deposits.

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[13] *Creditor position narrowed by around 2.3%, during the period, affected simultaneously by the fall in deposits by 1.4%, alongside the increase of credit by 2.9%. Credit in ALL grew by 4.9% compared the growth by only 0.5% of credit in foreign currency; while deposits in ALL and foreign currency fell by 1.8% and 1.0%, respectively.*

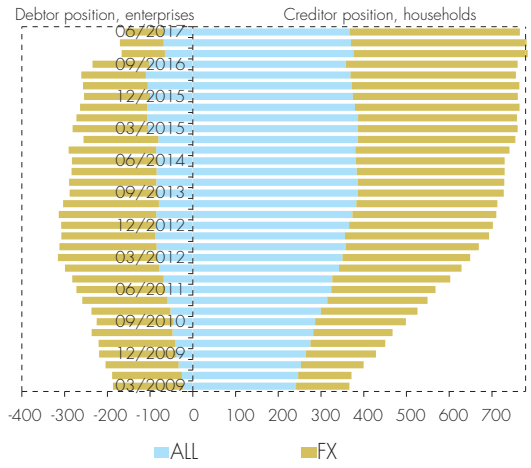
[14] *The debtor position narrowed during the period by 5.1%, due to the narrowing of the position in foreign currency (12.2%), mainly attributable to the fall of credit in this currency (6.6%). Meanwhile deposits fell by 1.4%, mainly affected by the fall of deposits in ALL by 2.4%, against the fall by 0.8% of deposits in foreign currency.*

[15] *In annual terms, creditor positions of households expanded by around 1.2%, attributable to the expansion of the position in foreign currency by 2.9%.*

[16] *The narrowing of debtor position, in annual terms, was around 39% and was affected by both, the narrowing of position, both, in ALL and in foreign currency (37.1 % and 41.1%, respectively). The fall of credit for both positions (ALL: 20.0% and foreign currency: 18.9%) was accompanied by a growth of the relevant deposits (20.6% and 23.7%, respectively).*

[17] *Creditor position in ALL fell at 2.4% against that in foreign currency by 2.2%.*

Chart 4.1 Financial position of households and enterprises, in ALL billion



Source: Bank of Albania, Financial Stability Department.

(22) Focusing on resident households, during the period, savings in the form of foreign currency deposits reduced and shifted to savings and investments in lek, in other assets of the financial system. Hence, the share of deposits in foreign currency against the total assets of resident households in the financial system dropped at 39.2%, while the share of investments in treasury bills, bonds and investment funds increased during the period (see Table 4.1).

Table 4.1 Households' assets in the financial system, ALL billion

	2010		2013		2016, June		2016, December		2017, June	
	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %	ALL bln	Share %
ALL deposits	357.6	49.8	449.5	43.7	450.4	40.3	454.3	40.3	465.1	42.1
FX deposits	304	42.3	418.4	40.7	455.6	40.8	476.4	42.3	432.8	39.2
T-Bills	56.7	7.9	70.6	6.7	72.4	6.5	65.2	5.8	67.3	6.1
Bonds	0.37	0.05	39.8	3.9	66.4	5.9	64.5	5.7	67.9	6.1
Investment funds*	-	-	50.3	4.9	71.7	6.4	65.4	5.8	70.8	6.4
Private voluntary pension funds*	0.12		0.43	0.04	1.1	0.1	1.2	0.1	1.3	0.1
Households portfolio	718.8	100	1,029	100	1,117.60	100	1,127.00	100	1,105.20	100.00

Source: Bank of Albania, FSA.

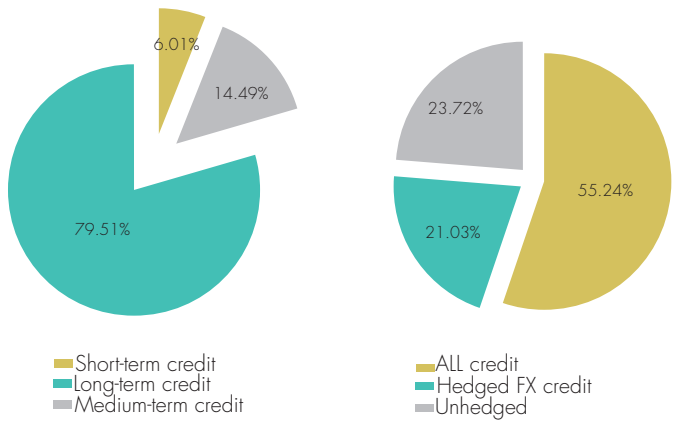
4.1.1 LENDING TO HOUSEHOLDS AND CREDIT RISK

(23) During the period, the expansion of credit to households was mainly attributable to the domestic currency, while credit in foreign currency expanded slightly. Hence, the share of credit in lek to households was up at 55.2%, around 3.3 percentage points higher than in June 2016. Unhedged loans to households in foreign currency fell both in annual and half-yearly terms, by reducing the exposure against the unfavourable movements of the exchange rate. The share of unhedged loans in foreign currency against the total outstanding credit in foreign currency to households dropped at 53.0%, from 55.1% and 53.9% in June and December 2016.[18] Around 79% of household unhedged loan consists in "House purchase loans", which fell by 3.3 percentage points, over a one year period. By maturity, long-term credit to households increased slightly by 1.1 percentage points, reaching at 79.5% of

[18] *The developments in the share of unhedged credit in foreign currency against total outstanding credit to households were at the same direction. This ratio fell both in annual and half-yearly terms. It stood at 23.7% in June 2017, compared with 26.9% and 25.7%, in June and December 2016, respectively.*

the portfolio; short-term credit fell at 6.0%, and medium-term credit accounted for 14.5% of the portfolio, down by 0.4 percentage point, respectively.

Chart 4.2 Structure of credit to households by maturity (left) and currency (right)

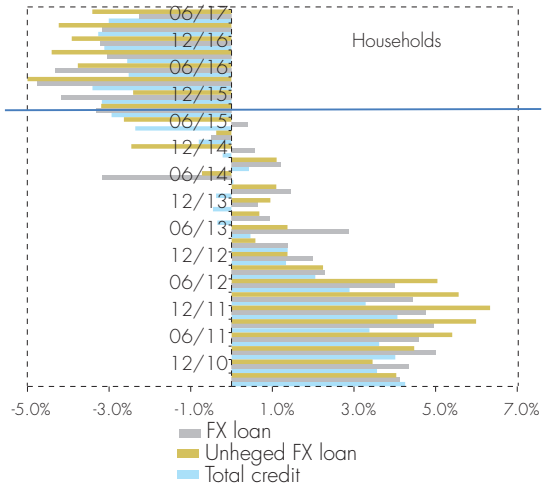


Source: Bank of Albania, Financial Stability Department.

(24) The quality of credit portfolio to households continued to improve, attributable to the loss loans write off from banks' balance sheets. The non-performing loans ratio for households fell at 9.4%, around 3.1 percentage points lower than in the previous year. The credit quality improved more considerably for the foreign currency credit, and for its part that is unhedged against fluctuations in the exchange rate. The ratio of non-performing loans in foreign currency to households dropped at 11.1%, down by 2.3 and 1 percentage points, in annual and half-yearly terms, respectively. The non-performing loans ratio of credit unhedged against the movements in the exchange rate further dropped at 10.6%[19].

(25) During the period, credit to resident households continued to accelerate, expanding both in annual and half-yearly terms, by 3.7% and 2.5%, respectively. This positive development was mainly affected by the expansion of credit for "non-durable goods" and for "real estate", where the latter shares 64% of total credit to this category of households.

Chart 4.3 Annual change of NPLR for households, in p.p.



Source: Bank of Albania, Financial stability Department.

[19] *This ratio was 14.0% and 11.2% at the end of June and December 2016, respectively.*

BOX 4.1. SURVEY RESULTS ON HOUSEHOLDS' FINANCIAL AND BORROWING SITUATION

The survey of households' financial and borrowing situation is conducted half-yearly. The survey is based on a randomly selected sample of 1,209 households, across around 55% urban areas and 45% rural areas.

In 2017 H1, the number of employed persons increased in annual terms, mainly supported by the employment in the public sector. The financial balance (income-expenses) of households was up, but the increase in expenses was higher, driving to a narrowing of households' financial balance (income-expenses). Around 28% of households say they have a loan to repay. This share is slightly lower from both 2016 H2 and the previous year.

In 38% of borrowing households had borrowed from formal sources (banks and non-bank institutions) in the form of credit products, and in 62% of cases from informal sources, mainly in cash. Compared with 2016 H2, this allocation has somewhat shifted in favour of the formal against the non-formal borrowing, as a result of the increase of bank borrowing. Consumption (40% of borrowing cases), purchasing/renovating a property (28% of cases) and business development (13% of cases) remained the top three purposes of borrowing. During the survey period, the shares of borrowing cases for consumption and purchasing property have been downward.

Total reported outstanding credit was up compared to both the previous survey, and the previous year. Around 80% of total outstanding credit is provided from formal sources and 20% from informal sources, remaining unchanged from 2016 H2. By currency, 92% of outstanding credit is in lek, and only 8% in foreign currency (mainly in euro). By purpose of use, around 56% of outstanding credit was for "Purchasing/renovating a property", 23% for "business development" and only 10% for "consumption" purposes.

The borrowing households say credit instalment during the referring period has fallen, reflecting the reduction of the weighted credit interest rate to households. The major part of borrowing households stated that their solvency has not changed during the period, while the rest mainly state a worsening. The major part of households (around 78%) does not expect any change of solvency in 2017 H2, the rest has optimistic expectation.

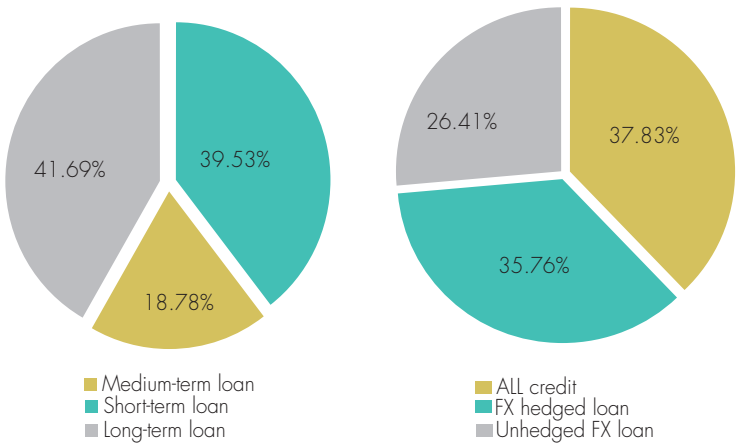
The possibility to receive a loan during 2017 H2 has resulted below the long-term average rate and trending down, by signalling a weakening of credit demand by households.

4.1.2 LENDING TO ENTERPRISES AND CREDIT RISK

(26) Credit to enterprises, accounting for 66% of total outstanding credit, fell slightly annually. In this portfolio, credit to resident enterprises had the main share, by 85%. It shrank both in half-yearly and annual terms, by 3.0% and 5%, respectively. During the period, outstanding credit for the "working capital" and for the "equipment purchase" shrank the most[20]. Meanwhile, annual developments show a fall in the credit stock also in the category "investments for real estate". By contrast, outstanding credit to non-resident enterprises expanded by 15.5% from the previous year, and around 2.1% during the period.

(27) In the structure of total credit to enterprises, the share of credit in the domestic currency was up, against the fall of credit in foreign currency. The share of credit in foreign currency in the total credit to enterprises dropped at 62.2% or 2.1 percentage points lower from the previous year. The outstanding credit unhedged against unfavourable volatilities in the exchange rate was also down; although its share in the total credit to enterprises has remained close the level of 26%.[21] In the structure of unhedged credit to enterprises, the shares of credit for "trade", for "real estate development" and for "business development" fell at 46.3%, 9.0% and 10.0%, respectively.

Chart 4.4 Structure of credit to enterprises by maturity (left) and currency (right)



Source: Bank of Albania, Financial Stability Department.

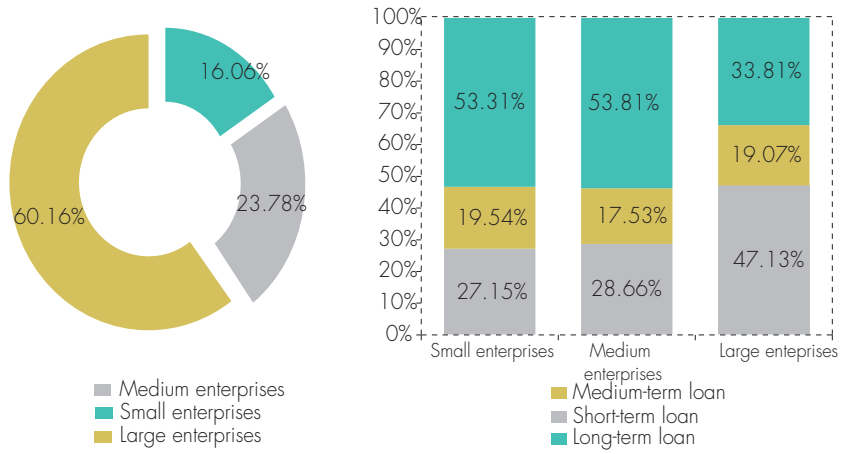
(28) In the stock of credit to enterprises, credit to large and medium-sized enterprises have the main share. The share of credit to large and medium-sized enterprises was up, accounting for 60.2% and 23.8% of the total, respectively. The share of credit to small enterprises fell at 16.1%. During the period, the small and medium-sized enterprises continued to increase the share

[20] *In more concrete terms, credit for working capital and equipment purchase fell half-yearly by 10.0% and 3.9%, respectively.*

[21] *Its share in June and December 2016, accounted for 26% and 27% of total credit to enterprises, respectively.*

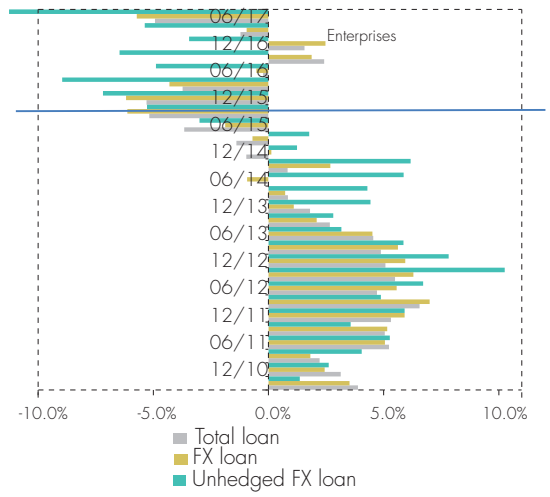
of long-term credit, whereas the large enterprises continued to be oriented towards the medium-term credit, recording small changes in the fall of long-term credit. By currency, the small enterprises decreased the share of credit in lek in favour of the one in foreign currency; while medium-sized and large enterprises expanded the credit in lek.

Chart 4.5 Structure of credit to enterprises by size



Source: Bank of Albania, Financial Stability Department.

Chart 4.6 Annual change of NPLR for enterprises, in p.p



Source: Bank of Albania, Financial Stability Department.

(29) Credit portfolio quality to enterprises, almost in all its components, improved considerably in annual and half-yearly terms. In June 2017, non-performing loans ratio to enterprises stood at 19.4%, from 23.0% in December 2016, and 24.4% in the previous year. The ratio of non-performing loans in foreign currency pursued a similar trend, falling at 19.6% at the end of the period, or 5.7 percentage points lower than the level of the previous year. The portfolio quality for unhedged foreign currency credit to enterprises improved significantly, annually and half-yearly, mainly affected by the loss loan write off process. At the end of the period, the ratio of non-performing loans for this category dropped at 16.7%, from 22.2% at the end of 2016, and 26.3% in the previous year.

BOX 4.2 SURVEY RESULTS ON ENTERPRISES FINANCIAL AND BORROWING SITUATION

The survey of enterprises' financial and borrowing situation is conducted half-yearly for eight years now. The latest survey was realised in the period May-June 2017, focusing on the developments in 2017 H1, while expectations refer to 2017 H2. The survey was conducted with a sample of 1,238 enterprises (small, medium-sized, and large enterprises), across the country, operating in major sectors of the economy. At the beginning of the year this sample was renewed for 10% of it.

During 2017 H1, competition continued to be considered by all groups of enterprises as the main problem to their activity. The importance of this factor is assessed upward to all sizes of enterprises, compared with 2016 H2. Finding a market also is assessed as another important limiting factor to the activity of the three groups of enterprises, in particular, to small and medium-sized enterprises. Problems related to access to finance are assessed as upward for small enterprises, while costs of financing are assessed as downward to medium-sized and large enterprises.

Medium-sized and large enterprises assess the level of sales as upward, during 2017 H1, while it was assessed as downward for small enterprises. Medium-sized and large enterprises assessed the financial result as upward, in line with the performance of sales, during the period. The positive performance of both sales and financial result was reflected in the expansion of the activity of medium-sized and large enterprises. Overall, the positive expectations of enterprises about the sales, the financial result and the expansion of the activity provide optimistic signals regarding their performance in the short and medium term.

During 2017 H1, almost half of respondent enterprises financed their activity through sales. Borrowing as a separate or combined source was used by 29.9% of large enterprises, 25.8% of medium-sized enterprises and 22.9% of small enterprises.

Around 40% of total enterprises (438 enterprises) state that they have a loan to repay. This share dropped compared to 2016 H2, for all the three groups of enterprises, but more emphasised for medium-sized enterprises. Around 89.3% of total borrowing enterprises state that they have turned to banks for borrowing. This share accounts for 92.1% of total formal sources (banks and non-bank financial institutions). Informal sources share 7.9% of total borrowing, where borrowing from natural persons has the highest share (2.8%).

Enterprises borrowed primarily to cover current expenditure and to conduct long-term investments. Compared to the previous survey, the share of enterprises that have borrowed to conduct long-term investments was up for the medium-sized and larger enterprises, while it was slightly down for small enterprises. Around 78% of small enterprises, 78.6% of medium-sized enterprises and 77.3% of larger enterprises consider the level of borrowing for financing their activity as adequate. Compared with 2016 H2, this share was up for both small and large enterprises, but downward for medium-sized enterprises.

Borrowing is reported in the domestic currency for 47.2% of total enterprises. Borrowing in the European currency has the main share of 49.4%, while the share in US dollar was 3.3%.

Only 10% of small enterprises and 11% of medium-sized and large enterprises report new borrowing during the period.

The overall value of the loan is about half the value of the enterprise's capital for 79.4% of borrowing enterprises. By size, debt share is higher for small enterprises, where around 24.3% of them stated that the value of the loan is equal or higher than the value of capital. The majority of borrowing enterprises (73.4%) state that the loan payment to revenues amounts up to 20% of revenues, trending down from the previous period. The burden of the loan payment appears to be heavier on small enterprises. The number of small enterprises reporting that the payment of the loan exceeds 20% of revenues accounts for around 33% of the total group.

Bank borrowing is assessed between "normal" and "difficult", while the importance of relationship with banks is assessed between "important" and "indispensable", for all the three groups of enterprises (small, medium-sized and large enterprises). More than half of the responded enterprises (51.3%) have reported that they do not intend to request a banking loan in the next half of year. This share is down for small and large enterprises, but up for medium-sized enterprises. There is an increase in the share of enterprises in the entire three groups reporting that there is a slight possibility to borrow in the next half of year.

4.2 REAL ESTATE MARKET

(30) The banking sector is exposed either directly or indirectly to the developments in real estate market[22], which consist in the performance of supply and demand, the volume of sales and performance of prices in the market. According to INSTAT data for the end of 2016, a considerable increase of the construction land and permits for housing was reported, while the construction cost continued the upward trend started since 2016 Q2. Also data reported by the banking sector for 2017 H1, show a slight increase of outstanding credit for real estate[23], accompanied by an increase of credit interest rates and slightly improvement of credit quality. The non-performing loans ratio for this type of credit dropped at 8.3%, from 8.8% in December 2016, and 10.4% a year earlier. Outstanding credit for construction has not changed considerably from December 2016, although it fell by 1.6% from the previous year, driving its share to be down at 13.6% of outstanding credit to enterprises, considerably below the level of around 20% recorded during the period 2007 – 2011.

(31) At the end of the period, banks reported a slight growth of real estate collateralised credits, at 50%, from 49% six months ago. Around 67% of

[22] *In this case, the exposures is represented by the loan granted or collateralised by real estate; loans to companies operating in construction sector; and the real estate loans portfolio that is established in banks as e result of taking the collateral following the execution of the obligation.*

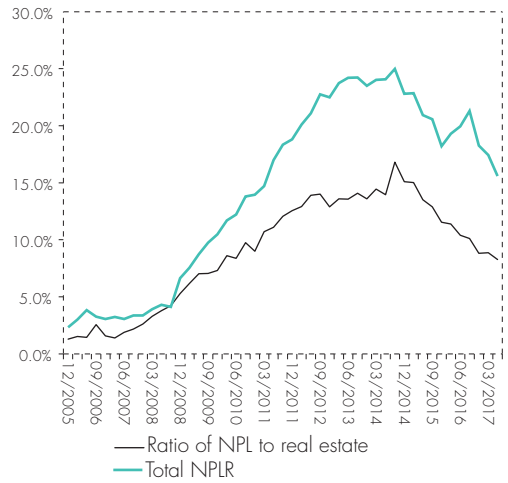
[23] *By only 0.2%*

credit to households and 43% of credit to enterprises was credit collateralised by real estate. This ratio was up for households and down for enterprises. Bank of Albania's bank lending survey for 2017 Q2 shows that households' demand for real estate credit was slightly up, while standards on credit approval were reported eased to

Chart 4.7 Credit for real estate purchasing and cost of credit payment

Source: Bank of Albania, Financial Stability Department.

Chart 4.8 Non-performing loans ratio



Source: Bank of Albania, Financial Stability Department.

households and somewhat less eased to enterprises[24].

(32) The weighted interest rate on the real estate credit[25] was 4.5%, slightly up during the period, but remaining in line with the downward trends in the recent years.[26] Along the same lines, the relative repayment cost[27] of real estate purchase increased, reflecting somewhat more tight conditions for real estate purchase from the borrower's perspective.

[24] *According to the Bank Lending Survey 2017 Q2, banks report that households' credit demand was slightly up for house purchase (the balance was slightly positive, at 1.6%).*

[25] *To calculate this rate, the interest rate is weighted for credit for real estate purchase to households, and for enterprises for real estate investment to enterprises.*

[26] *Average interest rate for real estate during 2008-2013 was 8.7%.*

[27] *The relative repayment cost of credit real estate purchase is measured as the difference between the interest rate on real estate loans and the average house price rise rate for the four previous quarters. The increase in this difference implies higher relative costs.*

BOX 4.3 REAL ESTATE MARKET AND HOUSE PRICE INDEX, 2017 H1 SURVEY

The situation in the real estate market is assessed through the field survey of a sample consisting in 230 real estate agents and construction firms, representing around 75-80% of the sample of these entities by size of activity. The Bank of Albania compiles the questionnaire and the data entry and processing, while the Institute of Statistics performs the field interviews, the main processes of sampling and the physical check of the filled questionnaires.

The net balance of responses of – 11.6% for the question "How do you assess the market situation compared with the previous period" shows a higher number of agents providing negative response (worse) than the positive response (better). This value is somewhat more negative compared with 2016 H2 (-8.6%), reflecting a slight worsening of agents' assessment for the market situation. As expected, the same indicator assessed only for the entities reporting sales during the period, shows a considerable more positive assessment; the net balance of responses on the overall situation by the entities reporting sales is around + 22%.

Fischer House Price Index, on a national level, was 5.3% higher than the level of the base period, year 2013. This development was affected by the increase in the sales volume in the other areas. On the other hand, price index at the national level is 7% lower from the previous period. For Tirana, the index fell slightly compared with the base period by 2.2%, and by 16.7% compared with the previous period. In the coastal areas, the agents reported lower average prices than those of the base period, but around 7% higher than those of 2016 H2.*

Agents report almost the same number of houses recorded in their books; the net balance between those reporting increase and those reporting decrease recorded in their books stands at slightly positive values. Related to commercial properties, the net balance is -3.8%, from the positive value 2.6% in the previous period. The number of unsold properties, both for residential and commercial buildings was down; the net balance was positive, showing less unsold properties, for the second successive period, since the start of the survey, though at more moderate values compared with 2016 H2.

The average time of sale for real estate, at the national level, is 10 months, or around 3.7 months shorter compared with 2016 H2. For Tirana, the respondent entities reported an average time of sale of 9.5 months, considerably lower compared to 13.8 months in 2016 H2. For the coastal area, the average sale time increased, from 8.4 months to 11.7 months, while for the other areas, the entities reported a considerable fall in the same sale time with the previous period, from 15 months to 9.7 months.

According to agents, around 72%, of properties for both, residential and commercial buildings sold by them, are purchased with loans. This figure is slightly up compared with 68% in the previous period. The loan-to-value ratio accounts for around 64% of the house value, higher from 53% in the previous period.

Agents are optimistic about the market performance in the territory they operate in the short-term future and considerably more positive for the long-term period (up to two years). The number of properties expected to be registered for sale during the forthcoming period is assessed as downward. Agents expect increase of real estate prices. The net balance was positive (11.4%), the most positive expectation since the beginning of the survey.

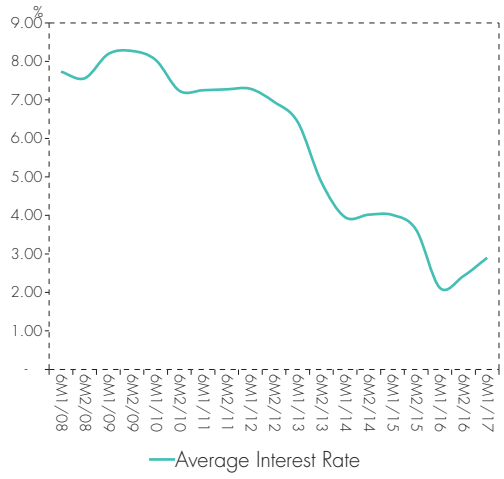
* *"Other areas" include all the areas, except for Tirana and the coastal area.*

5. FINANCIAL MARKETS

5.1 SECURITIES MARKET

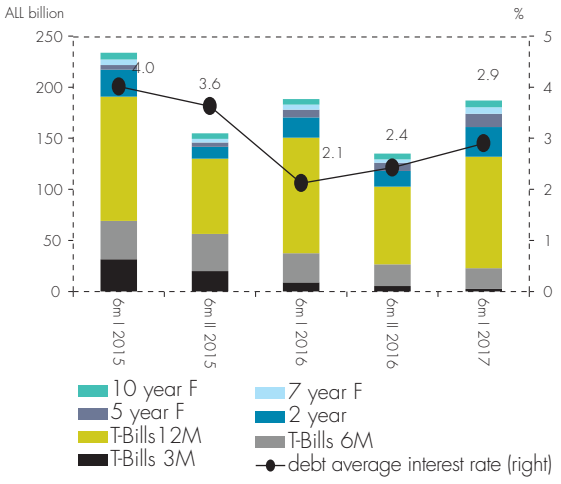
(33) During the period, average interest rates for government debt securities increased in both half yearly and annual terms. As at end 2017 H1, the average interest rate of the government debt was 2.9% or 0.5 p.p. higher than at the end of the previous period and 0.8 p.p. higher than a year earlier. Yields in the auctions of debt securities primary market rose as a result of the increase of yields on T-bills. The latter continue to dominate the structure of domestic debt in lek, with around 70%. Domestic debt in lek issued during 2017 H1 was around ALL 190 billion, 36% higher than the debt issued during the second half of the previous year, but comparable with the value of a year ago.

Chart 5.1 Average interest rate performance of debt issued in securities, in %



Source: Bank of Albania, Financial Stability Department.

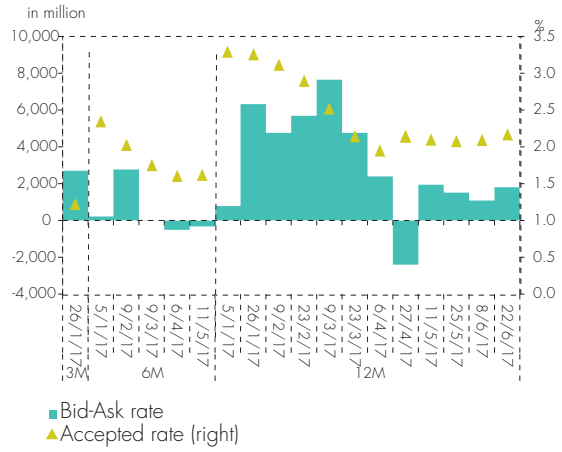
Chart 5.2 Composition of debt issued during 2015-2017 H1



Source: Bank of Albania, Financial Stability Department.

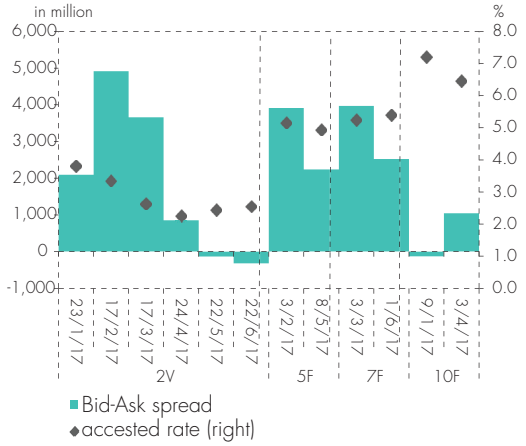
(34) Issues and average interest rates of short-term government debt increased compared with the previous six months. Issues of government debt securities in the form of T-bills were around ALL 130 billion, or around 30% higher than 2016 H2, but 12% lower than the value of a year earlier. Within short-term debt, 12-month maturity bills account for around 83% of the total. Average interest rates on T-bills for the 3 maturities increased by 0.5 p.p. from the previous period and by 0.8 p.p. against a year earlier, reaching 2.4%. In some T-bills auctions, and mainly those of 6-months maturity, the supply for investment was lower than the demand for borrowing or the amount announced by the government, due to the decline of the yield for this maturity. As a consequence of the higher preference by the investors, the yield on 12-month bills decreased from 3.3% in the auctions at the beginning of the year to 2.2% at the end of June.

Chart 5.3 Investment announced amount surplus and T- bill yields, for 2017 H1



Source: Bank of Albania, Financial Stability Department.

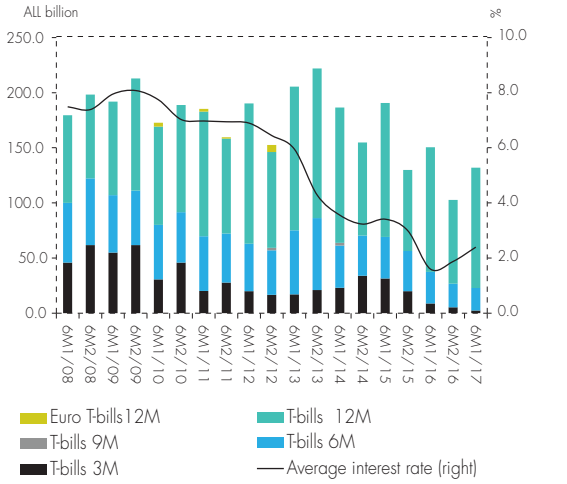
Chart 5.4 Investment announced amount surplus and bond yileds, for 2017 H1



Source: Bank of Albania, Financial Stability Department.

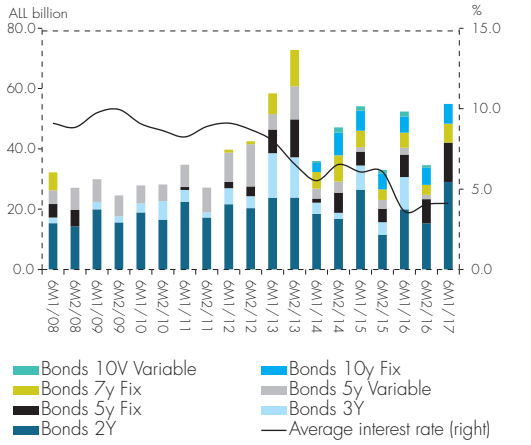
(35) Issued government long-term debt during the period was higher than in the previous period, while the average yield did not mark significant changes. Government debt securities issues in the form of bonds amounted to around ALL 55 billion, or around 60% higher than in 2016 H2, but 5% higher than in the same period a year earlier. Around 77% of the issued bonds volume consists of 2 and 5-years fixed interest rate bonds. The bonds' weighted average rate in lek for the first half of the year was 4.1%, 0.1 p.p. higher than in 2016 H2 and 0.5 p.p. higher than a year earlier. The increase of the weighted interest rate of bonds in lek during the 2016 H2 was reflected in the increase of the demand for investment in these securities in 2017 H1. Overall, the amount offered for investment in bond auctions was higher than the amount asked by the government; however, in some auctions, in which a declining trend of the yield was noted, the offer for investment was lower than the demand for borrowing.

Chart 5.5 Volume and weighted average rate bonds in the primary market



Source: Bank of Albania, Financial Stability Department.

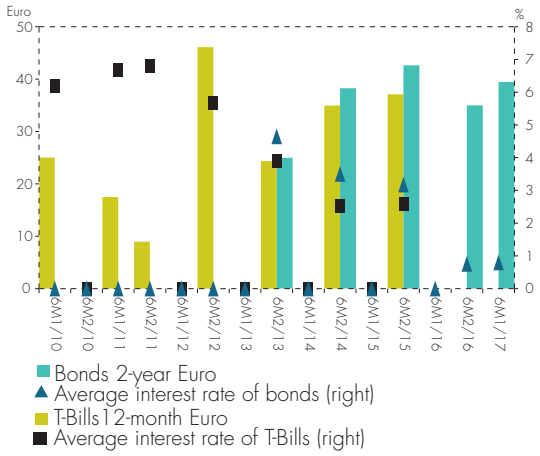
Chart 5.6 Volume and weighted average rate of T-bills in the primary market



Source: Bank of Albania, Financial Stability Department.

(36) At the beginning of the year, the government reissued in the domestic market medium-term debt in euro in the form of 2-year bonds. This was the only issue in euro in 2017 H1 and represents around 3% of the domestic debt issued during the period. The debt in euro issued in January 2017 and amounted to around EUR 39 million, 13% higher than the amount issued during the previous period. The higher demand of the government for domestic borrowing in euro was accompanied with the increase of the security yield at 0.80% from 0.75% registered in the previous six months.

Chart 5.7 Domestic borrowing in euro

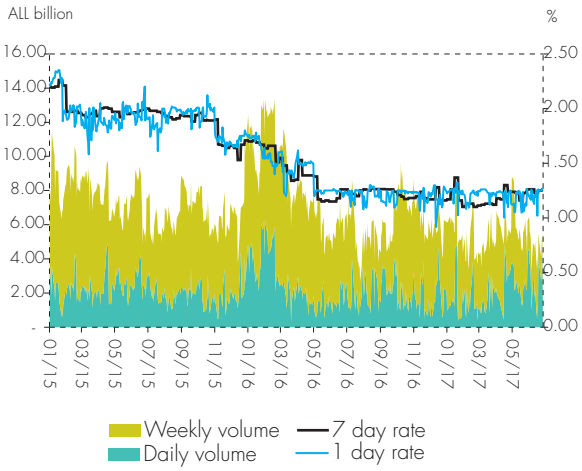


Source: Bank of Albania, Financial Stability Department.

5.2 INTERBANK MARKET

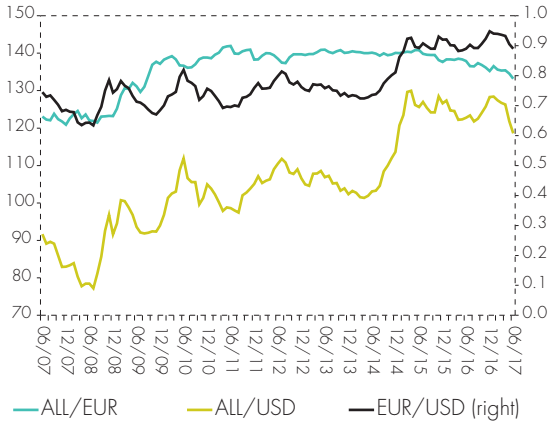
(37) During the period, the average volume of transactions in the interbank market declined compared with the previous six months, while interest rates remained close to the policy rate. The unchanged policy rate during the period favoured low interest rates in the interbank market. Banks have traded overall lower volumes at rates constantly below or close to the policy rate level, thus reflecting a stable liquidity situation. In 2017 H1, the average interbank overnight rate remained unchanged compared with the average of the previous period, at 1.20%. The average interest rate for 7-day transactions was 1.19% or 0.03 p.p. lower than the average in 2016 H2. The average volume of overnight borrowing increased 1.7% from the previous six months. Despite the low interbank rates, the average volume of 7-day transactions marked a decrease compared with the previous period. The 1-month borrowing rate also declined during this period, although this instrument is rarely used and at lower volumes compared with the shorter-term borrowing instruments.

Chart 5.8 Interbank rates



Source: Bank of Albania, Financial Stability Department.

Chart 5.9 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania, Financial Stability Department.

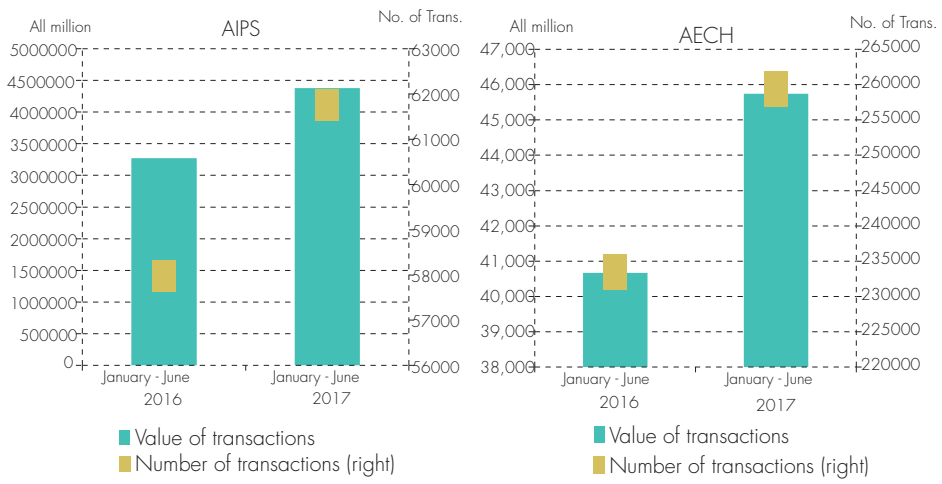
5.3 FOREIGN EXCHANGE MARKET

(38) During the period, the Albanian lek appreciated against the euro and against the US dollar. Compared with the end of December 2016, at the end of the period, lek appreciated by around 2.0% against the euro, and around 10.2% against the US dollar. Developments in the ALL/USD rate overall have reflected the performance of the US dollar exchange rate in the international markets. In average half-yearly terms, the domestic currency appreciated by 2.5% against the euro and by 0.6% against the US dollar, compared to a year earlier.

6. PAYMENT SYSTEM DEVELOPMENTS

(39) **The underlying infrastructure for the clearing and settlement of payments in the domestic currency continued to function securely and efficiently, thus supporting the financial stability and monetary policy implementation.** In terms of processing activity, during the period the AIPS system cleared 61,756 payments amounting to ALL 4,375 billion, 6.5% and 33.7% higher than the same period last year, respectively. In parallel, during the period the retail payment system AECH, cleared 259,364 payments, with an average value per transaction amounting to around ALL 176,000. Compared with the same period in the previous year, the activity of the AECH increased both in volume and value by 11.12% and 12.49% respectively.

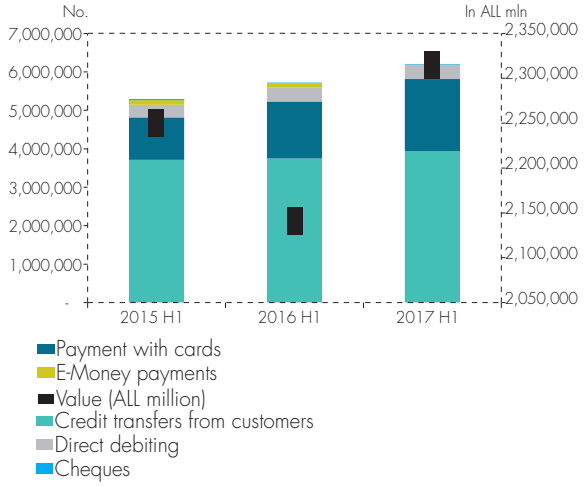
Chart 6.1 Activity in AIPS and AECH during 2016 H1-2017 H1



Source: Bank of Albania.

(40) **Regarding payment instruments, in 2017 H1, around 6.3 million payments were conducted, totalling ALL 2.310 billion.** The volume of transactions increased by 10.2% and the value was up by 8.1% compared with the same period a year earlier. Credit transfers continue to dominate payment instruments, but the share of this instrument has declined dictated by the decrease in volume and value of these instruments in the form of paper and non-paper (internet banking, mobile banking).

Chart 6.2 Performance of payment instruments in volume and value



Source: Bank of Albania.

7. FINANCIAL SYSTEM

(41) The share of the activity of the financial system in the Gross Domestic Product (GDP) is estimated downward during the period, but the main financial indicators overall improved. The decrease of the share of banking activity contributed most to the decline in the share of the financial system. The non-banking sector maintained its share to GDP, and non-bank financial institutions, private pension funds and investment funds made positive contributions to its performance. The direct exposure of the banking sector in the non-banking sector is assessed as low, whereas the performance of the banking sector remains a critical factor for the activity and stability of the non-banking sector. In the structure of the non-banking sector assets, investments in debt securities of the Albanian Government remain relevant and marked an increase in 2017 H1. Particularly for the banking sector, the indicators of capitalisation, profitability and liquidity remain at adequate levels.

(42) Developments in the activity of banks, savings and loan associations and insurance companies provided the main contribution to the decline of the share of the financial system activity in GDP. Total share of banking sector assets decreased at 91.9% of GDP, against 94.9% at the end of 2016. Banks continue to dominate the structure of the financial system assets, accounting for 89.7% of it, down during the period. As a result of the dominance of the banking sector in the financial system, the ratio of the financial system asset28 against GDP declined at 101.9%, around 3 p.p. lower than at the end of 2016. In annual terms, the activities of the banking sector, non-banking financial institutions and private supplementary pension funds increased.

Table 7.1 Share of financial system segments in GDP, over years

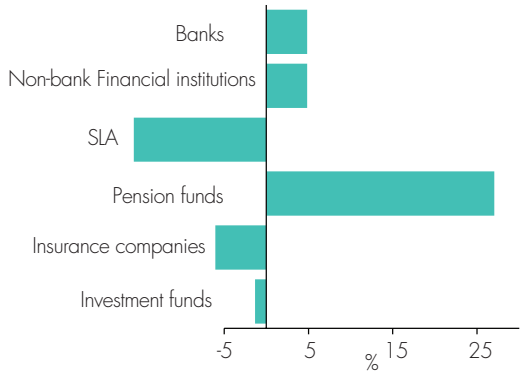
Licencing and supervising authority	Financial system	2011	2012	2013	2014	2015	2016	2017 H1
Bank of Albania	Banking sector	84.7	89.6	90.5	91.7	91.3	94.9	91.9
	NBFIs	2.5	2.7	2.5	2.7	2.7	2.9	2.8
	SLAs and Unions	0.7	0.8	0.8	0.8	0.7	0.6	0.5
Financial Supervision Authority	Insurance companies	1.5	1.6	1.6	1.7	1.9	2.1	1.9
	Pension funds	0.01	0.02	0.03	0.04	0.1	0.1	0.1
	Investment funds		1.21	3.7	4.5	4.7	4.4	4.7
Financial intermediation	89.41	95.93	99.13	101.44	101.3	105.1	101.9	

[28] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. In this chapter's analysis, consider that only the data for the banking sector are from 2017 H1. The data from the other segments of the financial system are from 2017 Q1.*

7.1 BANKING SECTOR DEVELOPMENTS

INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA

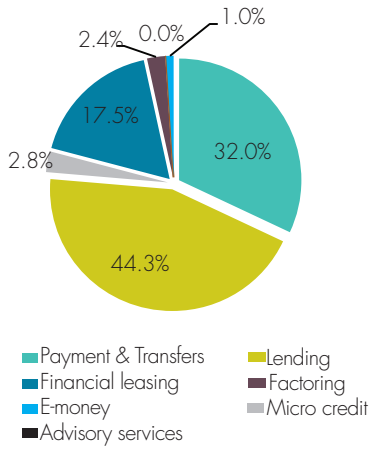
Chart 7.1 Annual growth of financial system components



Source: Bank of Albania, Albanian Financial Supervisory Authority.

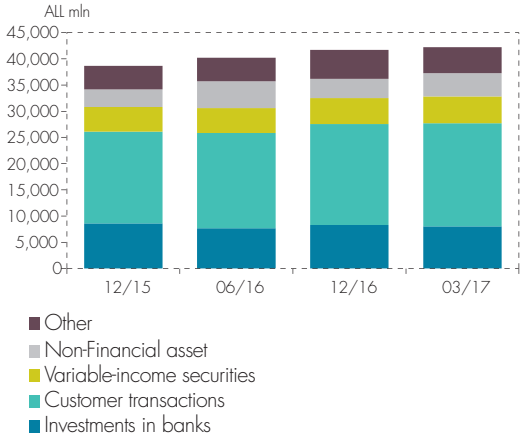
(43) During the period, non-banking financial institutions (NBFIs) expanded their activity and showed good financial indicators. Namely, assets' increase was supported by the expansion of lending and investment in securities. The NBFIs' financial result was positive; capitalisation was adequate although asset's quality has declined. In 2017 H1, the financial system had 28 NBFIs engaged mainly in microcredit, lending, leasing, factoring, electronic money etc. Lending NBFIs had the main share, followed by those that provide payment and transfer services. NBFIs' assets registered ALL 42.2 billion, up by 1.28% against the end of 2016 and by 6.5% against a year earlier. The main share in the structure of assets was from "customer transactions", which represent the lending activity, followed by investments in banks in the form of deposits and current accounts, which have given the main contribution to the expansion of the assets. Enterprises account for around 86% of the credit portfolio of NBFIs, mainly operating in the trade (23.3%) and agriculture (13.9%) sectors. The financial result of NBFIs resulted positive, around ALL 0.14 billion, but downward from a year earlier (ALL 0.34 billion).

Chart 7.2 Structure of NBFIs by type of activity



Source: Bank of Albania, Financial Stability Department.

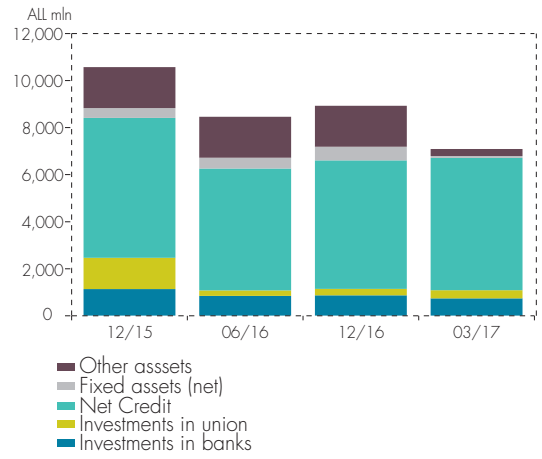
Chart 7.3 Structure of the assets of NBFIs



Source: Bank of Albania, Financial Stability Department.

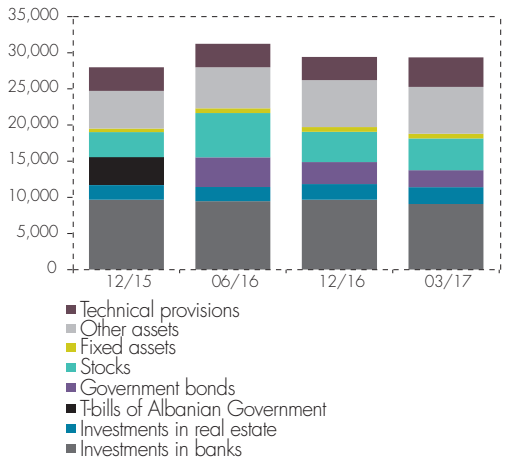
(44) The activity of savings and loan associations (SLAs) was positive during the period; but it contracted from a year earlier. The SLAs assets performance was determined by the decline in both investments in the banking sector and in

Chart 7.4 Structure of savings and loan associations



Source: Bank of Albania, Financial Stability Department.

Chart 7.5 Structure of assets in insurance companies



Source: Bank of Albania, Financial Stability Department.

shares. The main activity of these institutions registered an increase despite the overall performance of the activity. The financial result of SLAs returned to positive terms (around ALL 17 million) compared with the financial loss of a year earlier (around ALL 40.6 million). Loans to customers, investments in banks and other assets (mainly investments in shares) represent the main items of the assets of these institutions. In 2017 H1, thirteen active savings and loan associations operated in the market.

INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY

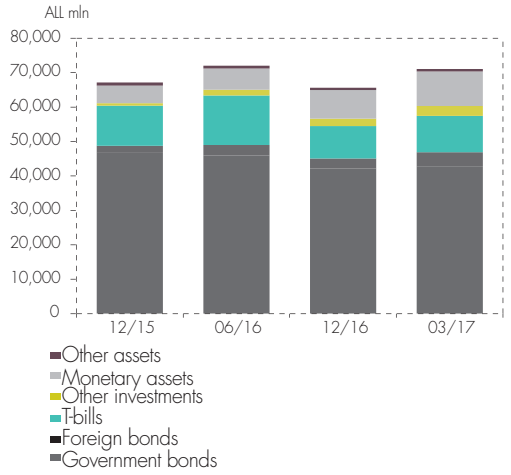
(45) The activity of insurance companies was overall stable during the period.[29] In 2017 H1, there were 12 licensed insurance companies.[30] The assets of these institutions remain very close to the levels of end-2016, at around ALL 29.3 billion. Their activity is mainly concentrated in investments in the form of time deposits, government debt securities and shares. Overall, insurance companies maintained capital levels supported by a positive financial result.

In the insurance activity, gross written premiums and paid claims were upward. Premium income (which is paid in advance) is used for paying liabilities and covering costs that may arise when an insurance event occurs. Gross written premiums[31], which represent the main financing source for the insurance companies activity, expanded by 12.0% in annual terms. The insurance market penetration indicator, measured as the ratio of premiums against GDP was at 0.5%, unchanged from a year earlier. The loss indicator, or the ratio of paid claims against gross written premiums, increased at 36.5% from 28.4% of a year earlier. This development reflects the faster growth in paid claims compared to the growth in gross premiums income. The value of gross paid claims increased by 44.0%, in annual terms, to ALL 2.7 billion.

[29] *Data are from 2017 Q1.*
[30] *8 non-life insurance companies, 3 life insurance companies and 1 reinsurance company.*
[31] *AFSA, "Insurance Market Statistical Report: January-June 2017", published on 25 July 2017.*

(46) The activity of investment funds[32] expanded, as a result of the increase of investments in banks and government debt securities. The investment fund is an entity with open participation, created on the basis of a contract, through public supply of quotas[33] that represent the rights and the interest of the investors. The return rates by the participation of investors in investment funds is usually higher than that of deposits in banks, reflecting the higher risk profile[34] of investment funds. Currently, three investment funds operate in the Albanian financial system. Funds' assets are mainly invested in T-bills and bonds issued by the Government of the Republic of Albania in lek and euro. In 2012, investment funds had 7,149 members, while during the period, this number was around four times higher (31,235 members). The value of net assets in September 2012 stood at ALL 16.9 billion, whereas in 2017 the value of net assets was ALL 70.8 billion (4.7% of the GDP of Albania).

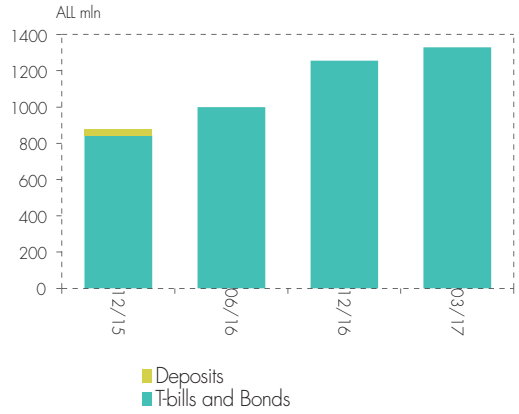
Chart 7.6 Asset structure of investment funds



Source: Bank of Albania, Financial Stability Department.

(47) Supplementary Private Pension Funds[35] have expanded their activity during the period. In Albania, 3 supplementary private pension funds operate in the financial market. At the end of 2017 Q1, the assets of these funds registered ALL 1.4 billion or 27% higher than a year earlier. The activity of pension funds is dominated by investments in government debt securities. The value of these investments was around ALL 1.3 billion or 5.8% higher than the end of 2016. According to the latest reports, the number of members of pension funds was 18,487.

Chart 7.7 Structure of investments in supplementary private pension funds



Source: Albanian Financial Supervisory Authority.

32 *AFSA, "General data on Investment Funds, 31 March 2017*

33 *Law, No.10198, dated 10/12/2009 "On Collective Investment Enterprises", AFSA.*

34 *In an extreme case related to unfavourable movements of the market and/or mismanagement of a fund, the entire value invested in a fund may be lost. In similar cases in banks, depositors' savings are protected at least up to ALL 2.5 million (in accordance with the provisions of the Law "On deposits insurance"). In any case, both investment funds and banks are subject to the regulatory requirements for their activity's financial indicators, in order to minimize the possibility of their failure.*

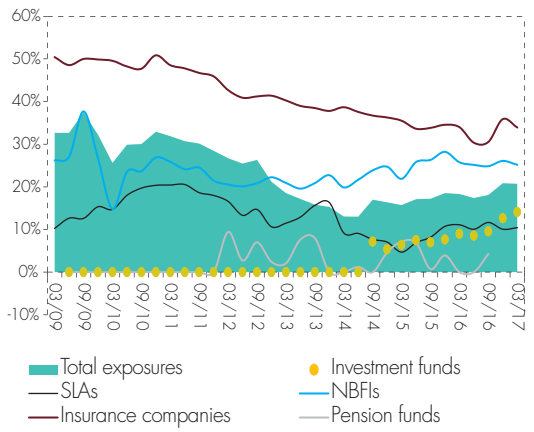
35 *AFSA, Statistical Report "Developments in the private supplementary pensions", 31 March 2017, published on 11 May 2017.*

7.2 ASSESSMENT OF RISKS AND EXPOSURES IN THE NON-BANKING SECTOR

(48) **The banking sector's exposure to the non-banking sector in Albania remained low.** This exposure on the side of banks' assets is represented by loans and participation in the capital of non-bank financial institutions; meanwhile, on the side of liabilities it is represented in the form of funds collected by them (various accounts). In total, this exposure ac counts for only 2.3% of the values of assets of the banking sector.

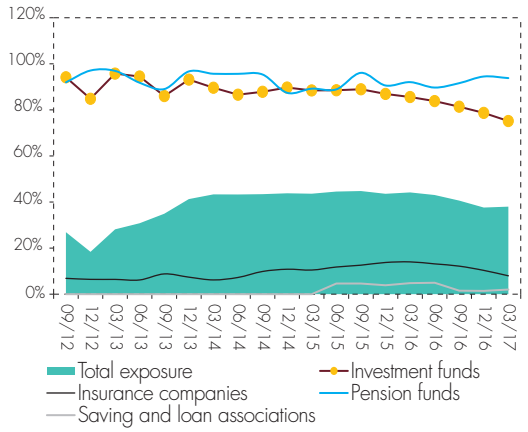
(49) **On the other hand, the sensitivity of the non-banking sector to the activity of the banking sector remains high. In total this exposure constitutes 20.7% of the assets of the non-banking sector, up by 2.4 p.p. against a year earlier.**[36] Insurance companies and non-bank financial institutions (NBFIs) show the highest exposure to the banking sector, as their placements in banks in the form of deposits and equity instruments constitute 33.9% and 25.2%, respectively, of the relevant assets. Investment funds and savings and loan associations also show upward exposures.

Chart 7.8 Exposure of main NBFIs to the banking sector, in relation to their total assets



Source: Albanian Financial Supervision Authority, data processed by the Bank of Albania

Chart 7.9 Investments of NBFIs in government securities, against their total assets



Source: Albanian Financial Supervision Authority, processed data by the Bank of Albania

(50) **Non-bank financial institutions and saving and loans associations, while active in lending, are exposed mainly to credit risk.** In March 2017, the ratio of non-performing loans against total NBFIs loans increased at 12.6% from 11.9% a year earlier, while for SLAs the quality indicator registered a decrease at 5.4% from 8.2% a year earlier.

(51) **Market risk affects most significantly the activity of life insurance companies, investment funds and private supplementary pension funds.** The manner of impact is explained in the previous Financial Stability Report, and

[36] *The data refer to 2017 Q1.*

is related mostly with the impact that the level or the movements of the interest rate and the exchange rate may have on the financial performance of the enterprise because of the duration gap, the type of currency or interest payment profile, amongst the liabilities and assets items in the balance sheet of these enterprises. During the period, interest rates remained at similar levels with the previous period and overall have shown low volatility. After operating for a relatively long time in an environment with low interest rates, the potential of their increase may be accompanied with negative effects in the balance sheets of these institutions. It is therefore necessary that they evidence and assess this impact regularly.

8. BANKING SECTOR DEVELOPMENTS

(52) During the period, developments in the banking sector have been positive, despite the overall contraction in the banking activity. *The banking sector's activity relied mainly on the increase of interbank investments, while investments in securities and lending decreased. The banking sector was characterised by a good level of capitalisation, liquidity and profitability. The continuation of the lost loans write off from the balance sheets of the banks has led to the slowdown of the increase of the non-performing loans. Despite this development, the banking sector continued to be exposed to credit risk. Exposure to market risks remains subdued, but it should be assessed regularly.*

8.1 BANKING ACTIVITY

(53) The activity of the banking sector contracted during the period, although the growth pace in annual terms remained high. Compared with the end of 2016, the assets of the banking sector decreased by 0.9%, reaching ALL 1.394 billion. The highest decline was registered in "Securities transactions"[37] mainly with non-resident entities, followed by "Transactions with the treasury"[38]. The lending activity has also registered contraction. "Interbank transactions" gave a positive contribution to the performance of assets[39], mainly in the form of deposits with non-resident entities. On the liabilities side, the main items continue to be "Costumer transactions", which represent the depositing activity and "Permanent resources", which represents the capital of banks or their own funds. The Albanian government's debt securities represent around 23% of the total assets from 22% in the previous quarter[40]. In annual terms, total assets of the banking sector grew 4.8%. The growth in assets, in annual terms,

[37] *Investment portfolio in securities decreased by about ALL 11.4 billion or 3.1% compared to the end-2016, down at ALL 356.9 billion. These investments mainly consisted in the form of securities of non-resident placement in foreign exchange, at ALL 71.4 billion, or 24.7% lower than December 2016.*

[38] *Interbank and treasury transactions marked a half year decline by around ALL 9.5 billion, at ALL 452.7 billion. The main contribution in the contraction of this item was the decline of the transactions of banks with the central bank in the form of current accounts. They decreased by around ALL 24 billion, at ALL 33.4 billion. The decline of transactions with the treasury defined the performance of the item "Treasury and interbank transactions".*

[39] *Interbank relations gave a positive contribution to the performance of assets, expanding by around ALL 20.3 billion at ALL 233.7 billion, mainly in the form of deposits into banks, lending institutions and other financial institutions with non-resident entities. These deposits increase by around ALL 23.9 billion, at ALL 112 billion.*

[40] *The increase of investments on government debt securities was totally derived from the expansion of bonds portfolio. In 2017 H1, T-bills portfolio narrowed by ALL 7.8 billion compared with December 2016, at ALL 61.2 billion, while bonds portfolio increased by around ALL 14.7 billion, at ALL 255.4 billion.*

resulted from the increase in interbank and securities investments, mainly in the government debt securities, but also in securities issued by non-resident entities.

Table 8.1 Structure of banks' balance sheet, June 2017

Assets	% of assets	Annual change, %	Liabilities	% of liabilities	Annual change, %
I. Treasury and interbank transactions	32.5	7.5	I. Treasury and interbank transactions	4.6	9.4
II. Customer transactions (credit)	42.9	-0.03	II. Customer transactions (deposits)	81.7	3.5
Of which: public sector	2.2	7.9	Of which: public sector	1.9	-10.3
Of which: private sector	40.7	-0.4	Of which: private sector	79.7	3.9
III. Securities transactions	25.9	5.6	III. Securities transactions	0.5	921.5*
IV. Created Reserve funds	-4.9	-13.6	IV. Other liabilities	0.9	28.7
V. Other**	3.6	6.2	V. Permanent sources	12.2	6.8
			of which: Subordinated debt	1.6	-0.01
			Of which: Shareholder's equity	9.9	8.3
Total assets	100	4.8	Total liabilities	100	4.8

Source: Bank of Albania, Financial Stability Department.

* *Investments in securities pruchased and sold via REPO with non-residents, which are concentrated.*

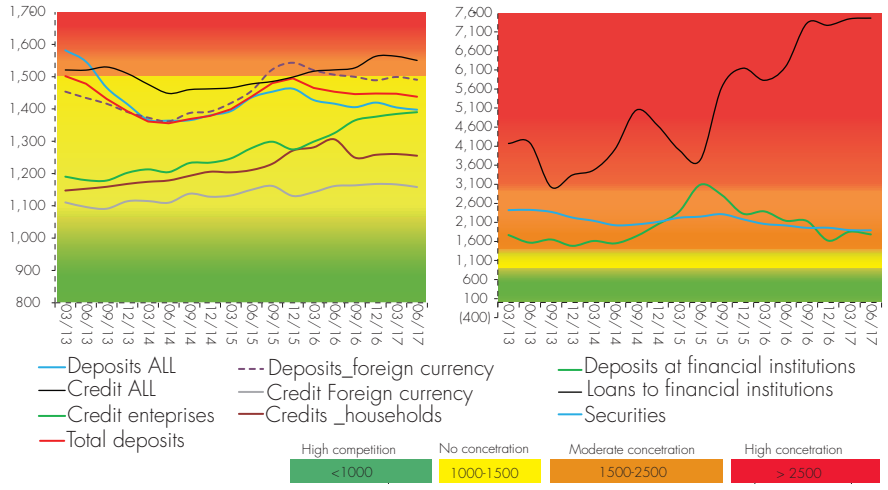
** *"Other" in the balance sheet refers to "Other assets" and "Fixed assets".*

(54) The banking activity was mainly financed by deposits, which accounted for about 81.4% of total assets. In June 2017, the deposit/credit ratio stood at 52.5%. The deposit stock declined in half-yearly terms by around 1.6% and expanded in annual terms by around 3.5%; the main contribution came from foreign currency deposits. The current accounts[41] continued to give the main contribution to the expansion of the deposits base. This development signals a potential weakness regarding the structure of the funding of the banking sector, which, however, is relatively mitigated by the fact that 83.5% of deposits are from households and, overall, the average maturity of the liabilities has increased due to the expansion of the stock of deposits with 12-month maturity. Banks have maintained the capital utilisation ratio to finance their operations, in compliance with the relevant regulatory capital requirements.

(55) The Albanian banking system is characterised by a high concentration for some of its activities. Chart 8.1 (left) shows some of the banking products (in the bank's assets and liabilities) for which the banking sector shows a moderate or lower concentration. Amongst them, for indicators like overall deposits or credit in lek, the degree of concentration has trended down, while for credit to enterprises the concentration has increased significantly since 2015 H2. Chart 8.1 (right) shows the banking sector's activities with a higher concentration, mainly on the assets side of the banking sector's balance sheet, including lending, mainly with non-resident financial entities.

[41] *In June 2017, the share of current accounts was 32.3%, from 28.5% in June 2016. The share of time deposits declined at 57.5% from 62.7% of a year ago. During this period demand deposits have seen an increase of their share at 8.3% from 7.9%.*

Chart 8.1 Herfindahl indicator for the main banking products



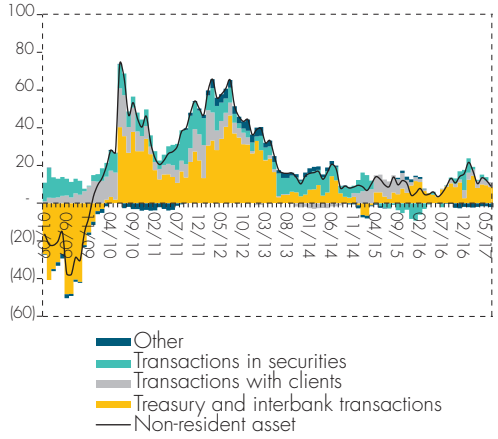
Source: Bank of Albania, Financial Stability Department.

8.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

(56) As the banking activity continues to be predominantly funded by domestic sources, the reliance of the banking sector on external sources remains limited. Net position of the banking sector to non-residents remained on the crediting side and continued to increase during the period. Borrowing from banking groups remained low.

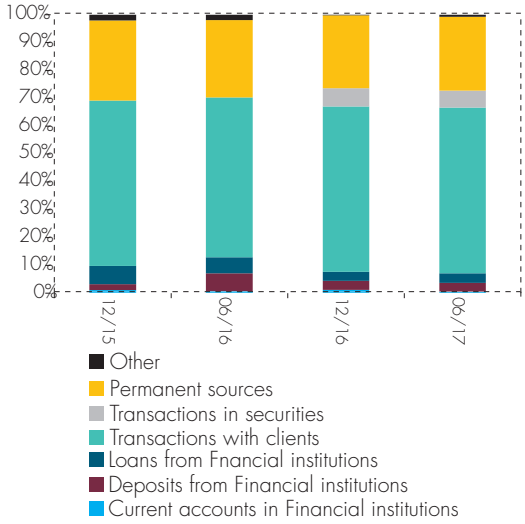
(57) The banking sector has expanded the credit position to non-resident entities. At the end of the period, assets with non-residents accounted for 27% of total assets and liabilities to non-residents only 5.9% of them. As a result, the net credit position to non-residents expanded by around 0.6% in half-yearly terms, and around 11.7% in annual terms, reaching ALL 294.5 billion. The higher annual growth in transactions with non-residents on the asset side is noted in "Treasury and interbank transactions" and "Costumer transactions", altogether by around 15.5%. Liabilities to non-residents consist mainly in "Costumer transactions" (deposits by non-residents in domestic banks), as well as "Permanent sources" or their own funds. During the period "Interbank transactions" decreased, mainly deposits and current accounts by non-resident financial institutions, which shows a further decline of foreign sources of funding.

Chart 8.2 Contribution to the annual growth of assets with non-residents in p.p.



Source: Bank of Albania, Financial Stability Department

Chart 8.3 Composition of non-resident liabilities



Source: Bank of Albania, Financial Stability Department

(58) Claims in the form of placements[42] in parent banking groups constitute only 3.3% of the banking sector assets, while liabilities for the same item account for 0.01%. Placements in the parent banking groups increased by 2% in annual terms. Around 56% of the placements' values were by G3 banks, 36% by G2 banks and around 9% by G1 banks. By capital origin, the Italian groups accounts for 34.3% of the total, while the Greek groups accounts for 23.2% of placements in the parent banking groups.

(59) The countercyclical measures taken by the Bank of Albania in May 2013 contributed to the deceleration of the growth pace of banking sector investments in non-resident entities, but this impact has been declining. In June 2017, the 9.1% annual growth pace of banking sector investments in non-residents was significantly lower than the around 25% growth pace of these investments at the time when the measures started to be implemented. However, the share of assets with non-residents, which are subject to the countercyclical measures, increased at 80% of total assets with non-residents, from 78.6% a year earlier. There is an expansion of interbank investments within the group of assets with non-residents that are subject of the aforementioned measures. On the other hand, the annual growth pace of assets with non-residents that are not subject to the countercyclical measures has been lower, registering 4.6% in June 2017. Amid sluggish lending and lack of other investment alternatives, despite the higher capital requirements burdened on banks for the change of placements with non-residents, in January 2017, the annual growth of investments was around 21.6%, the highest historical level after 2013. This significant expansion appeared mainly in the form of increase in interbank and securities investments, and followed the change in the implementation of the

[42] *Securities investments and credit for non-resident non-financial entities are not included.*

regulatory measure at the end of 2016.[43] In the following months, the pace of the expansion of investments in non-resident entities decreased gradually at 9.1%. During the rest of 2017, the Bank of Albania will continue to implement the measures that aim to decrease investments in non-resident entities in order to continuously boost domestic lending.

8.3 LENDING DEVELOPMENTS

8.3.1 OUTSTANDING LENDING

(60) During the period, outstanding loans decreased in the balance sheet of the banking sector. At the end of June 2017, outstanding loans in the balance sheet of the banking sector stood at ALL 597 billion[44], around 0.5% lower (or ALL 3.1 billion) than at the end-2016. Compared with a year earlier, outstanding loans remained almost unchanged. The performance of this activity is characterised by the significant decline of the non-performing loans (as a consequence of repayments, restructuring and partially the writing off of lost loans), the more sluggish performance of new lending and the reducing effect of the appreciation of the exchange rate of lek.

Table 8.2 Lending performance

	Indicator and unit	Value (ALL bln)	Share in total loans (%)	Share in total loans (%)	Change	Change
	Period	06/2017	06/2017	06/2016	from '12/2016	from '06/2016
By currency	ALL loans	256,21	42.9%	39.9%	3.2%	7.4%
	FX loans	341,08	57.1%	60.1%	-3.1%	-5.0%
By entity	Public sector	30,44	5.1%	4.7%	6.2%	8.0%
	Enterprises	393,49	65.9%	67.4%	-2.4%	-2.3%
	Households	173,36	29.0%	27.9%	2.8%	4.2%
By maturity term	Short - term	185,10	31.0%	33.1%	-3.0%	-6.3%
	Medium - term	119,04	19.9%	18.7%	-2.0%	6.3%
	Long - term	293,15	49.1%	48.2%	1.8%	1.8%
	Balance	597,28	100.0%	100.0%	-0.5%	0.0%

Source: Bank of Albania, Financial Stability Department.

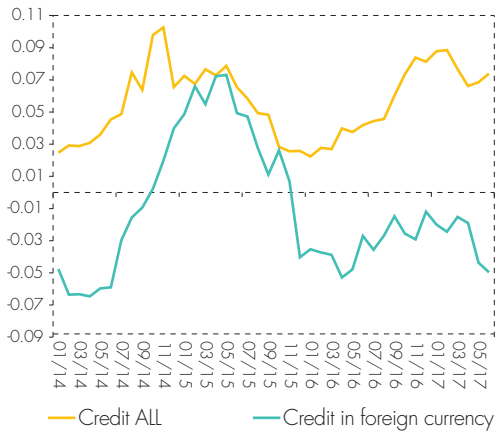
(61) By currency, foreign currency loans decreased by 3.1% (or ALL 11 billion) while lek loans increased by 3.2% (or ALL 7.9 billion), during the period. Because of the considerable share of foreign currency loans (57%), the performance of lek exchange rate affects the nominal value of credit being reported in the domestic currency. About the outstanding loans calculated at the end of June 2017, the appreciation of the lek against the main foreign currencies contributed to the decrease of the reported value of lending by

[43] *At the end of 2016, the Bank of Albania changed the manner of implementation of the regulatory countercyclical measure, where for the measurement of the change in investment with non-residents, is not used anymore a fixed base period (March 2013) but a 2-year moving time period. The aim of the change was to set an upper limit in the growth of capital demand by banks from this activity. The isolated and on-time impact of this change in the balance sheet of banks was expected to appear in the form of the decrease of risk-weighted assets and the improvement of the Capital Adequacy Ratio.*

[44] *Including accrued interests. Without them, credit outstanding is assessed around ALL 593 billion.*

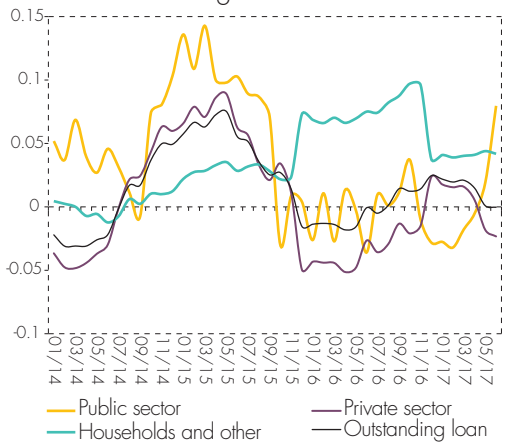
around ALL 8.7 billion. Excluding this effect, outstanding loans, during the period, would increase by 0.9% (from a decrease of 0.5%), while loans in foreign currency would decrease by around 0.7% (from a decrease of 3.1%). In annual terms, outstanding loans in the domestic currency expanded by 7.4%, while that of loans in foreign currency contracted by 5%.

Chart 8.4 Performance of credit by currency, annual growth



Source: Bank of Albania, Financial Stability Department.

Chart 8.5 Performance of credit by maturity, annual growth



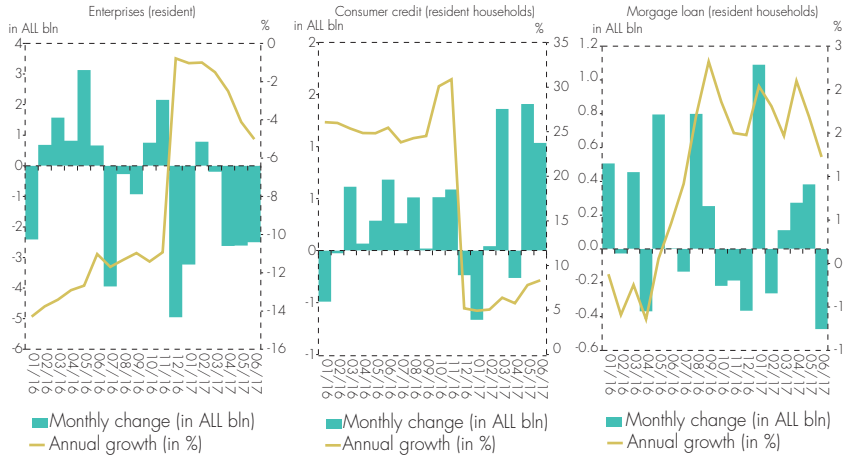
Source: Bank of Albania, Financial Stability Department.

(62) Short-term lending, which represents 26% of outstanding loans, has given the main contribution to its contraction during the period. Compared with the end of 2016, short-term and medium-term lending contracted by 3% and 2%, respectively, while long-term lending expanded by 1.8%. Over the course of a year, short-term lending decreased by 6.3%, while medium-term and long-term lending increased by 6.3% and 1.8%, respectively.

(63) Loans to enterprises, which constitute the main share of outstanding loans (around 66%), contracted during the period by 2.3%, down to ALL 393.5 billion. The decline came from the decrease of the non-performing loans stock, as a consequence of the writing off of lost loans, non-performing loans repayment and loans restructuring. Loans to resident enterprises, which constitute 85% of loans to enterprises, contracted during the period by around 3% (or around ALL 10 billion), while loans to non-resident enterprises expanded by 1.3% and at the end of the period reached ALL 59 billion. Loans to the public sector account for only 5% of overall lending and grew by 6.2% during the first half of the year. In annual terms, loans to enterprises contracted by 2.3% (around ALL 9.4 billion) reflecting the operations for collecting and restructuring loans as well as lost loans write off from the balance sheets. During the last 12 months, around ALL 7 billion in loans classified as "lost", borrowed by enterprises, have been written off. In annual terms, loans to the public sector have grown as well by 8.3% (or ALL 2.2 billion).

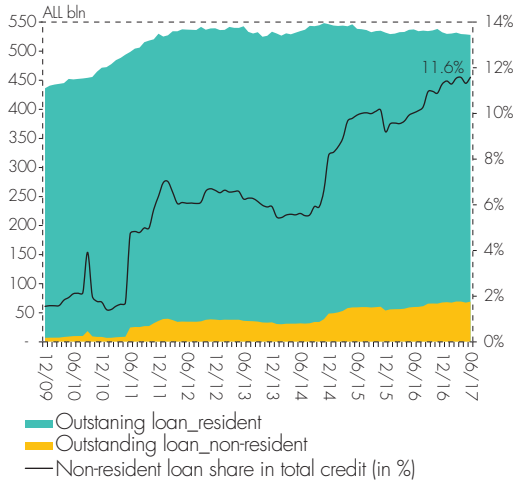
(64) Loans to households increased by 2.8% (or by ALL 4.7 billion) supported by the expansion of new lending for resident entities. Loans to resident households account for 95% of total loans to households and have increased by 2.5% (or ALL 4 billion) during the period. This performance is driven mainly by the expansion of consumer loans 5.2 % and mortgage loans[45] 1.1%. Loans to non-resident households increased by 7.3% over the period. In annual terms, total loans to households output has increased by 4.2% (or by ALL 7 billion). The expansion of loans to households is supported by new loans mainly for consumption.

Chart 8.6 Loans by purpose, annual growth (ra) and monthly change of the stock (la).



Source: Bank of Albania, Financial Stability Department.

Chart 8.7 Performance of loans to non-residents.



Source: Bank of Albania, Financial Stability Department.

(65) The banking sector continued to finance non-resident entities (enterprises and households). The share of loans to non-resident entities increased at 11.6% of the banking sector credit outstanding in June 2017, from 10% of a year earlier. Outstanding loans to non-resident registered ALL 69 billion, up by 2.1% during the period and 15.5% against a year earlier. Loans to non-resident enterprises contributed most to this increase, surging by 1.3% during the period and by 15.8% against a year earlier, accounting for 85% of the total. Almost all loans to non-residents were in foreign currency, and mainly in euro. Overall, loans to non-residents were oriented toward longer-term maturities, with the main share in the medium term (54%) and in the long term (31%). This type of lending was concentrated in a small number of banks.

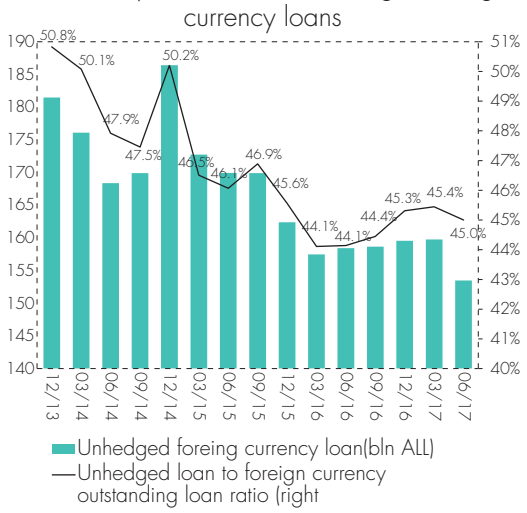
[45] *This type of lending accounts for 64% of outstanding credit to resident households.*

BOX 8.1. BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

The exposure of the banking sector to indirect credit risk, mainly in loans to enterprises, remains high. In June 2017, foreign currency loans unhedged against exchange rate fluctuations constituted 45% of total foreign currency loans (0.3 p.p. lower than at the end of 2016 and 1 p.p. higher than a year earlier) and 26% of total outstanding loans. Unhedged foreign currency loans, as part of overall lending, decreased by around 1 p.p. against both the end of the previous year and a year earlier.

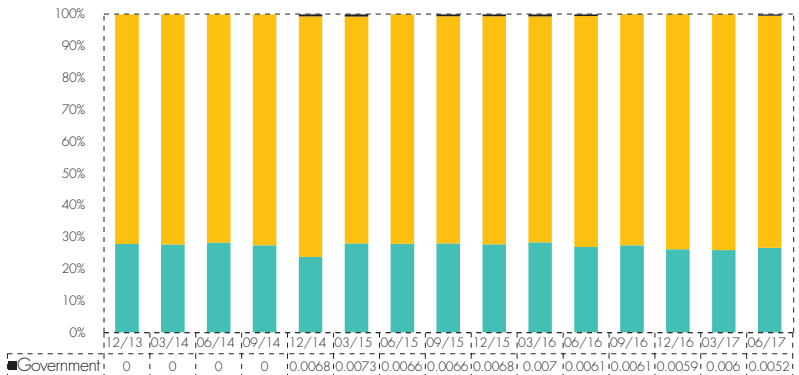
Unhedged outstanding loans during the period contracted by 3.8% at ALL 153.5 billion, due to the significant contraction of unhedged loans in US dollar, by around 41%. By entity, loans to enterprises account for the main share (73%) of foreign currency loans unhedged against the exchange rate risk and its decrease by 5% gave the main contribution to the contraction of unhedged foreign currency outstanding loans. Unhedged loans to households contracted by 2%. In annual terms, unhedged foreign currency loans contracted by 3.1% and reflect the decrease of unhedged credit outstanding for both types of entities, but mainly for enterprises.*

Chart 8.8 performance of unhedged foreign currency loans



Source: Bank of Albania, Financial Stability Department.

Chart 8.9 Unhedged foreign currency loans, by subject, %

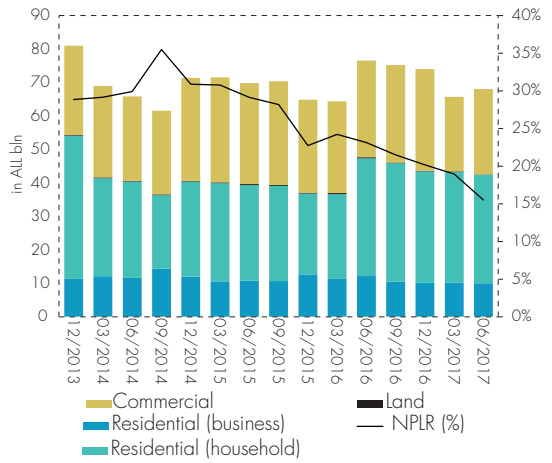


	12/13	03/14	06/14	09/14	12/14	03/15	06/15	09/15	12/15	03/16	06/16	09/16	12/16	03/17	06/17
Government	0	0	0	0	0.0068	0.0073	0.0066	0.0066	0.0068	0.007	0.0061	0.0061	0.0059	0.006	0.0052
Enterprises	0.7213	0.7231	0.7176	0.7257	0.7556	0.7126	0.7208	0.7135	0.7158	0.7093	0.7246	0.7255	0.7382	0.7405	0.7281
Households	0.2787	0.2769	0.2824	0.2743	0.2376	0.2801	0.2792	0.2799	0.2774	0.2837	0.2694	0.2745	0.2618	0.2595	0.2667

Source: Bank of Albania, Financial Stability Department.

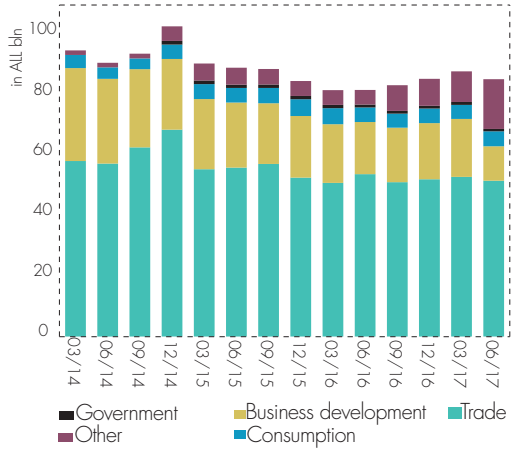
By purpose of use, loans for investments in real estate account for the main share of unhedged foreign currency loans (around 44%). This type of loans has decreased compared with the end of the previous year (8%) as well as compared with a year earlier (11%). The decrease is related to the rapid decline in the non-performing loans stock. Such loans are mainly granted to households for "investments in residential real estate". The rest of the unhedged foreign currency loans were granted mainly for trading and business development purposes (Chart 8.11).

Chart 8.10 Unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania, Financial Stability Department.

Chart 8.11 Unhedged foreign currency loans (not real estate)



Source: Bank of Albania, Financial Stability Department.

* *Outstanding US dollar credit, when the borrower's income is in Albanian lek, accounts for 12.5% of the outstanding unhedged foreign currency loans.*

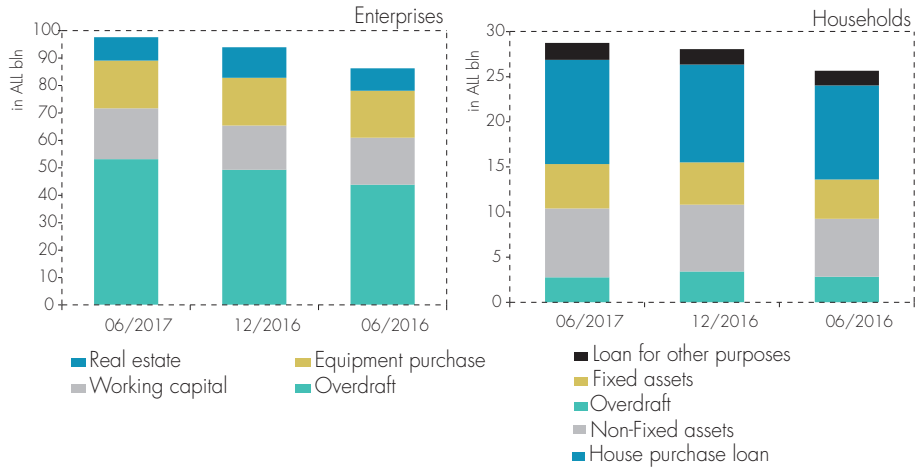
8.3.2 NEW LENDING

(66) During the period, the banking sector granted new loans for ALL 128 billion, while the lending collected during the same period was ALL 132 billion. New lending was around 9% lower compared with the previous period and around 13% higher compared with the first half of the previous year. Collected loans were around 12% lower compared with the previous period and around 23% higher compared with the same period in the previous year. The ratio of collected-to-new loans, declined at 103% from 107% at the end of 2016, and 95% a year earlier. The annual growth of the loan usage ratio came mainly as a consequence of the increase of the value of collected loans.

(67) During the period, the performance of new lending was determined by the change of new lending to the public sector. In the private sector, enterprises account for around 77% of new lending, mainly in the form of "overdraft" (short-term lending). New loans to enterprises were higher compared with 2016 H2 (4.5%) as well as compared with 2016 H1 (13%). The increase was due to the growth of lending in the overdraft form and lending for working capital. New loans to households were also up, mainly due to the increase of new loans for house purchase, which accounts for around 40% of new loans to households. Unlike the previous period, when new loans to the public sector amounted to around 13% of the new lending, loans to this sector accounted for a very small share of the new lending during the period (around 0.3%). The contraction

by ALL 17.3 billion of new lending for this sector contributed to the negative performance of new lending in 2017 H1. This effect is assessed as temporary, since loans to the public sector historically have a small share in total lending.

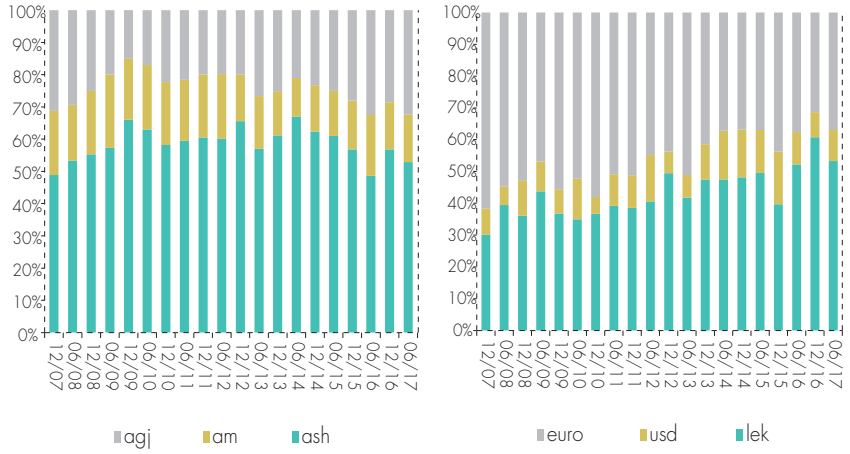
Chart 8.12 New credit by purpose



Source: Bank of Albania, Financial Stability Department.

(68) By currency and maturity, lek loans and short-term loans provided the main contribution to the performance of new lending during the period. New loans in lek accounted for 53% of the overall new lending flow. During 2017 H1, new loans in lek decreased by around 20% (or ALL 17 billion) compared with 2017 H2, but increased by 15% compared with 2016 H1. New foreign currency loans increased by around 10% from the previous period. Around 80% of new loans in foreign currency are euro loans, which were higher from the same period a year ago. By maturity, new short-term lending, which constitutes 53% of the total, gave the main contribution in the performance of new lending during the period. Although these loans increased by 23% in annual terms, they decreased by 15% in the period.

Chart 8.13 Distribution of new credit by maturity (left) and currency (right)

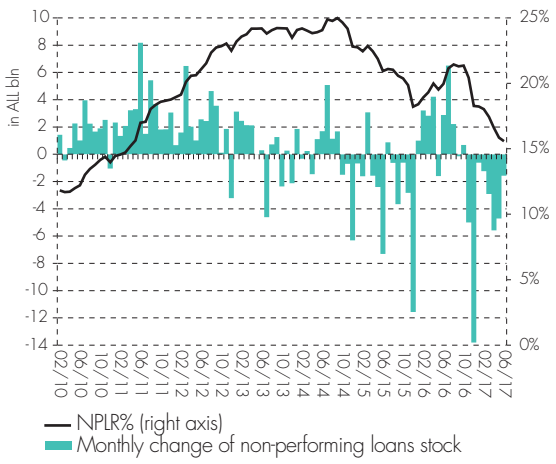


Source: Bank of Albania, Financial Stability Department.

8.3.3 CREDIT RISK

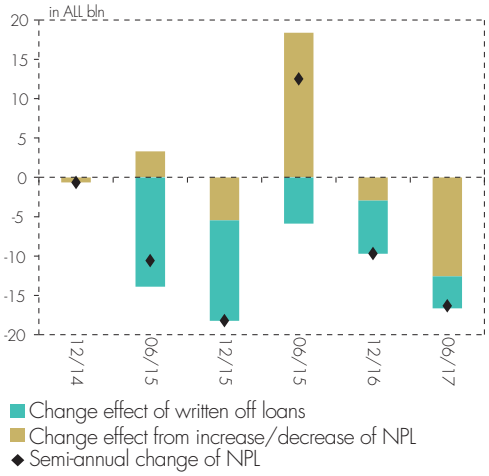
(69) During the period, outstanding non-performing loans[46] decreased significantly. At the end of the period, outstanding non-performing loans amounted to ALL 93 billion, or 15.2% lower than in 2016 H2. The decrease of non-performing loans is a result of restructuring, repayment of overdue loans by enterprises and the lost loans write off from banks' balance sheets. During 2017 H1, ALL 4 billion of lost loans were written off from banks' balance sheets, mainly foreign currency loans to enterprises. Restructured loans during this period were around ALL 6.2 billion. From this amount, ALL 1.7 billion were loans classified as "non-performing", the rest were "standard" and "special mention" loans. Compared with the previous year, non-performing loans stock declined by 22% (or ALL 26.2 billion). During the period July 2016 - June 2017 the banks have written off around ALL 11 billion lost loans[47] from the balance sheets.

Chart 8.14 Non-performing loans ratio



Source: Bank of Albania, Financial Stability Department.

Chart 8.15 Contribution in the half year change of the non-performing loans stock (ALL billion)



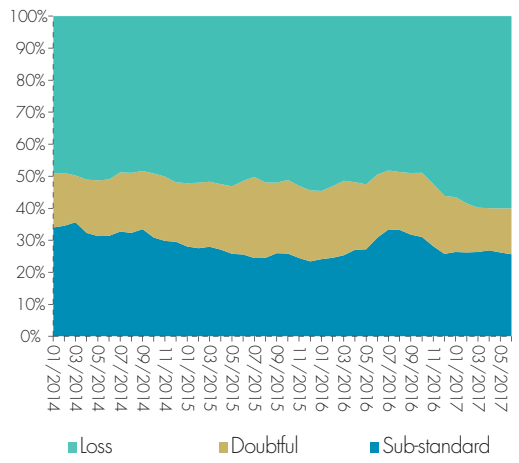
Source: Bank of Albania, Financial Stability Department.

(70) The decrease of outstanding non-performing loans is accompanied with the significant decrease of the non-performing loans ratio (NPLR). At the end of the period, NPLR marked 15.6%, around 2.7 p.p. lower than December 2016 and 4.4 p.p. lower than a year earlier. Within the structure of non-performing loans, due to repayment and restructuring, loans of the categories "substandard" and "doubtful" contracted by 15.6% and 32.8%, respectively. The loans classified "lost", which account for the main share, or around 60% of non-performing loans, contracted by 9.3% mainly due to their write off from the balance sheets.

46 *Non-performing loans include "substandard", "doubtful", and "lost" classes. The criterion to define a loan as "non-performing" is the number of past due days (90 days) and the financial situation of the borrower.*

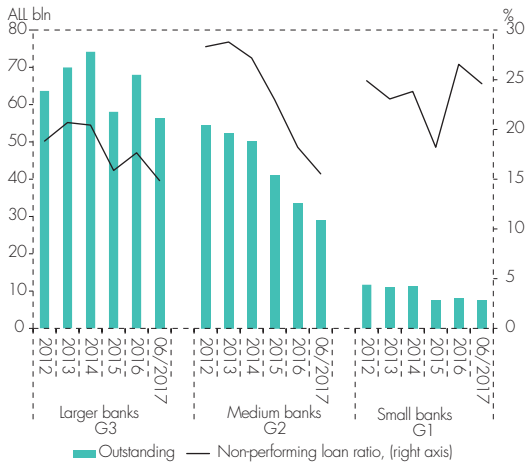
47 *Starting from January 2015, banks are obliged under the regulatory requirements to undertake the process of balance sheets cleaning - the write off of loans falling under the category "lost" for more than three years. In total, in two years and a half, ALL 43.3 billion of lost loans were written off.*

Chart 8.16 Non-performing loans structure



Source: Bank of Albania, Financial Stability Department.

Chart 8.17 NPL portfolio by bank groups



Source: Bank of Albania, Financial Stability Department.

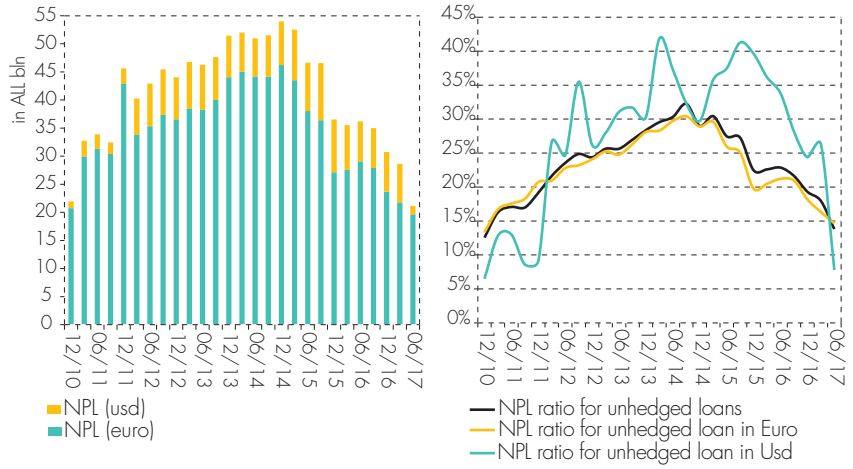
(71) Larger banks made the main contribution to the improvement of credit quality, together accounting for 61% of the outstanding NPLs. The NPLs for this group of banks contracted by 17.2%, whereas the NPLR decreased by 2.8 p.p. to 14.9%. Larger banks (G3) have the lowest non-performing loans ratio, while smaller banks (G1) having the highest NPLR at around 24.6%. The NPLR for this group decreased by 1.9 p.p.

(72) The credit quality appears lower for loans in foreign currency, loans to enterprises, and medium-term loans. At the end of 2017 H1, the credit quality for each portfolio stood at 17.6% (foreign currency), 19.5% (enterprises) and 17.0% (long-term). All these indicators have declined during the period.

Chart 8.18 Non-performing loans in the Albanian banking sector

Source: Bank of Albania, Financial Stability Department.

Chart 8.19 Quality of the loan portfolio unhedged against exchange rate risk

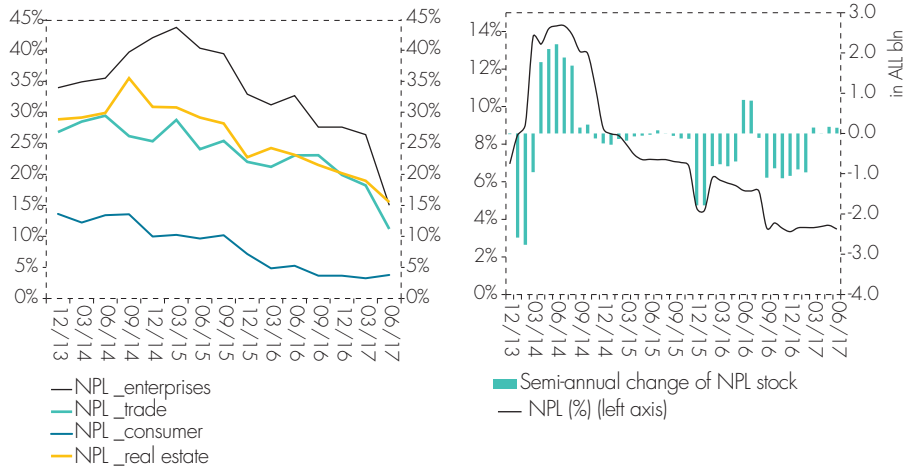


Source: Bank of Albania, Financial Stability Department.

(73) The quality of unhedged foreign currency loans has improved continuously since the beginning of 2015. The non-performing loans ratio (NPLR) for these loans decreased at 13.8% from 19.3% of December 2016, affected by the rapid decrease of the non-performing loans stock. During the period, the outstanding unhedged non-performing loans contracted significantly, by around 31%. By currency, the main impact in the improvement of the quality of unhedged loans came from loans denominated in the US dollar. The quality ratio for unhedged US dollar loans improved by 16.6 p.p., falling at 7.8%, and NPLR for unhedged euro loans improved by around 3.5 p.p., falling at 14.7%.

(74) By purpose of use, the main share in non-performing loans stock within unhedged loans from exchange rate risk were loans for "investments in real estate" (49%), which during the period decreased by 29.3%. This type of loans has the highest level of non-performing loans ratio, around 15.5%, followed by those for business development at 15%. During the period NPLR for these two categories decrease by 4.7 p.p. and 12.6 p.p., respectively. From the category of unhedged loans from exchange rate risk, consumer credit shows the lowest NPLR level, at 3.8%. While consumer credit accounts for 3.2% of total stock of unhedged loans against exchange rate risk, the share of non-performing loans from this credit in the stock of non-performing loans unhedged by exchange rate risk is around 1%.

Chart 8.20 Credit quality for the loan portfolio unhedged against exchange rate risk, by purpose (left) and non-performing loans for non-resident entities (right).



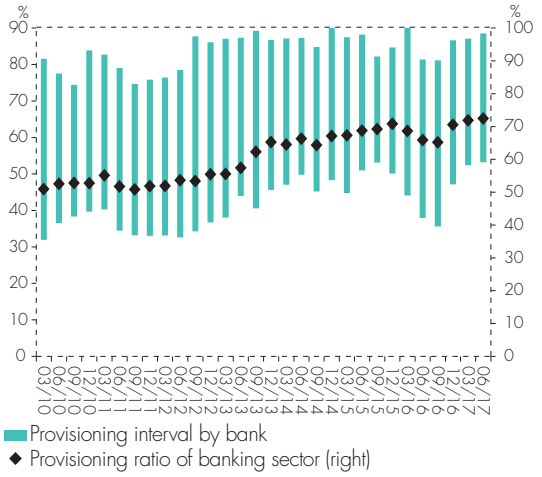
Source: Bank of Albania, Financial Stability Department.

(75) Credit quality for non-resident entities is considered relatively good; the NPLR for this type of credit is 3.5%, significantly lower than the overall outstanding credit NPLR. During 2017 H1 the stock of non-performing loans for non-residents expanded by 6.2%, reaching ALL 2.4 billion, while NPLR increased by 0.1 p.p. Compared with the previous year, the NPLR contracted by around 2.1 p.p. while the non-performing loans stock contracted by 27.4%.

8.3.4 CREDIT RISK MITIGATING FACTORS

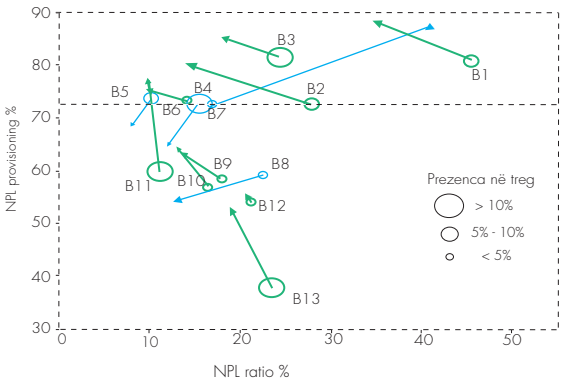
(76) Although the value of provisions for credit risk has decreased, the faster decrease of the non-performing loans stock has increased provisioning at 72.5% (or by 2.5 p.p.) during the period. Compared with the previous year, most of the banks of the system report both improvements in credit quality and a higher level of provisioning (Chart 8.21).

Chart 8.21 Provisioning over time



Source: Bank of Albania, Financial Stability Department.

Chart 8.22*. Annual change in provisioning levels - arrows show change from June 2016 to June 2017, by bank

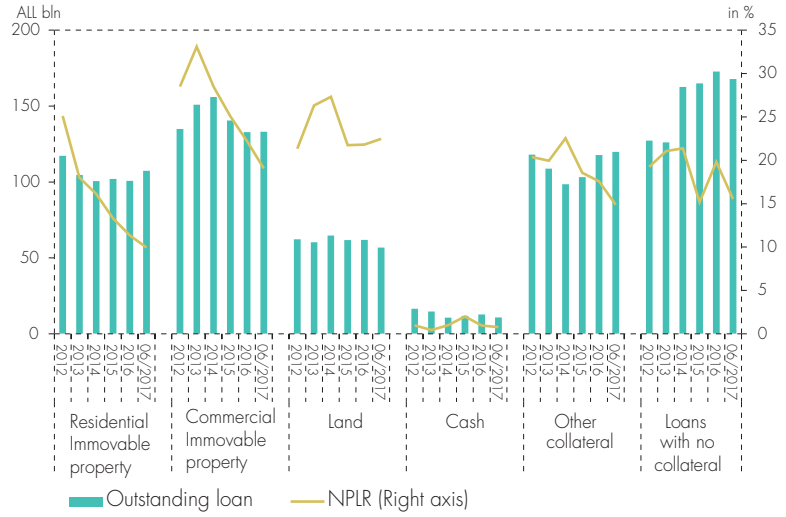


*Note: This includes banks sharing more than 1% in total assets. Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows the average ratio of non-performing loan provisioning at sector level, 72.5% at the end of June 2017.
Source: Bank of Albania, Financial Stability Department.

(77) The decrease in the net value of non-performing loans[48] during the period has led to an improvement in their capital coverage. During the period, the ratio of net non-performing loans to outstanding loans contracted by 1.1 p.p., to 4.3%. In the previous year, the ratio stood at 6.8%. At the same time, as a result of the lower exposure to credit risk through the contraction of the outstanding net non-performing loans, the "net non-performing loans/ regulatory capital" decreased to 18.6% from 23.1% at the end of December 2016. In the previous year, the ratio stood at 30.2%.

(78) Collateral coverage of loans remains high and, amongst the different types of collateral used to guarantee the loan, real estate continues to predominate. In June 2017, collateral coverage[49] marked 71.8%, from 71.2% at the end of 2016, and 71% a year earlier. Loans covered with collateral in the form of real estate account for around 70% of collateralized loans, and 50% of outstanding loans. Collateralized outstanding loans have slightly increased during the period (by 0.6%), mainly due to the increase by 7% of outstanding loans collateralized with residential real estate. The quality of collateralized loans has improved during the period compared with a year earlier, and NPLR marked 15.6%. Loans collateralized with cash have the lowest level of non-performing loans (0.8%), while that collateralized with "real estate - land" the highest (22.5%). The NPLR for this type of loans has grown. The quality of non-collateralized loans, which account for 28% of overall outstanding loans, has improved, which has been reflected in the decrease of NPLR at 15.5% from 19.8% of the end of previous year. The high degree of use of real estate as collateral to guarantee loans to enterprises and households highlights the importance of the good functioning and regulation of the real estate market, as well as the transparent and efficient implementation for all the parties of the legal obligations and the execution of liabilities, in the case of loans default.

Chart 8.23 Outstanding credit and non-performing loans ratio by collateral



Source: Bank of Albania, Financial Stability Department.

[48] *Net non-performing loans represent the value of non-performing loans that remains after provisions are deducted for these loans.*

[49] *Collateral in the form of real estate (residential, commercial or land), cash etc.*

8.4 DEPOSITS AND LIQUIDITY RISK

(79) Outstanding deposits declined during the period, mainly due to the appreciation of the lek exchange rate. Specifically, in June 2017, the deposits' stock in the banking sector was ALL 1.138 billion. During the period (compared to the end of 2016), outstanding deposits fell by about 1.7% or by about ALL 19.1 billion. By currency, deposits in lek fell by around ALL 6.6 billion, while outstanding deposits in foreign currency fell by All 12.6 billion. Regarding the performance of deposits in foreign currency during the period, the appreciation of lek provided a negative effect for around ALL 17.3 billion, exceeding the nominal value of the decrease in the outstanding deposits in foreign currency. This means that, according to transactions in their original currencies, foreign currency deposits[50], in total increased by about ALL 4.5 billion. Excluding the exchange rate effect, the total outstanding deposits, marks a much lower fall over the period, by ALL 2.2 billion or 0.2%. In annual terms, the total outstanding deposits grew by 3.5%. Foreign currency deposits account for around 53% of the outstanding deposits of the banking sector.

Table 8.4 Main indicators of deposits in the banking system

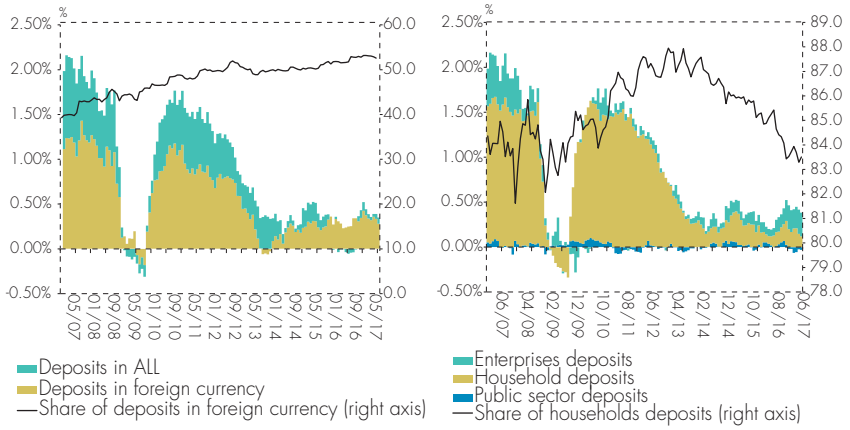
	Indicator and unit	Value (in ALL billion)	Share to total deposits (%)		Change	
	Period	06/2017	06/2017	06/2016	Annual	Semi-annual
By currency	Deposits in lek	540	47.4%	48.4%	1.5%	-1.2%
	Deposits in foreign currency	599	52.6%	51.6%	5.4%	-2.1%
By institution	Public sector	28	2.4%	2.8%	-11.5%	-5.7%
	Enterprises	160	14.1%	11.9%	22.2%	-1.5%
	Households	951	83.5%	85.3%	1.4%	-1.6%
By product	Current account	368	32.3%	28.5%	17.2%	-1.6%
	Demand deposits	95	8.3%	6.9%	24%	3.8%
	Time deposits	655	57.5%	62.8%	-5.1%	-2.2%
	Deposits' stock	1.138	100.%	100.%	3.5%	-1.7%

Source: Bank of Albania, Financial Stability Department.

(80) During the period, households and enterprises' deposits decreased by 1.6% and 1.5%, respectively. Since households' deposits account for 83.5% of the total deposits, with half of them in foreign currency, they were the main contributor to the decrease of the deposit base, narrowing by around ALL 15 billion. Households' deposits in foreign currency fell faster during the period, by ALL 8.8 billion, compared with the fall by only ALL 0.8 billion of enterprises' deposits in foreign currency. In annual terms, both households and enterprises' deposits grew by 1.4% and 22.2%, respectively.

[50] *This excludes the effect of the exchange rate change and only reflects the net (inflow-outflow) movements of deposits by original currencies.*

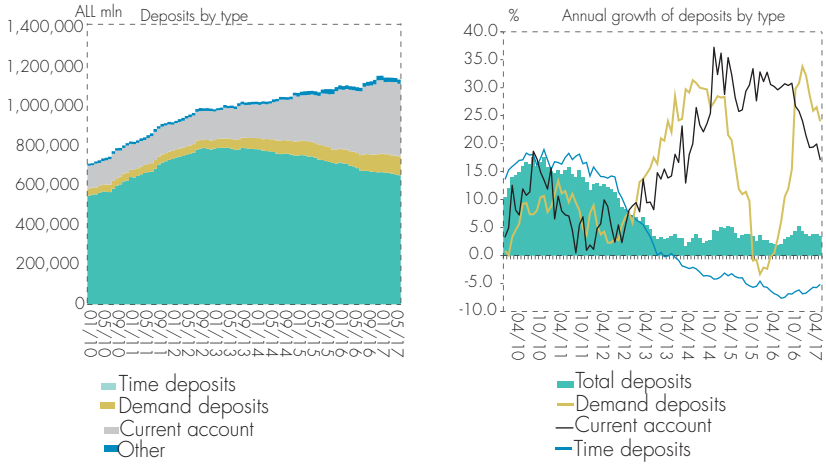
Chart 8.24 Contribution to the performance of deposits



Source: Bank of Albania, Financial Stability Department.

(81) Time deposits continue to have the main share in the total value of deposits, but they shrank in absolute and relative terms to deposit stock[51]. During the period, time deposits fell by ALL 14.5 billion or 2.2%. The stock of current accounts also decreased by ALL 6.1 billion, during the period. Only time deposits contributed to the growth of deposits stock, by ALL 3.5 billion, during the period.

Chart 8.25 Deposits by type



Source: Bank of Albania, Financial Stability Department.

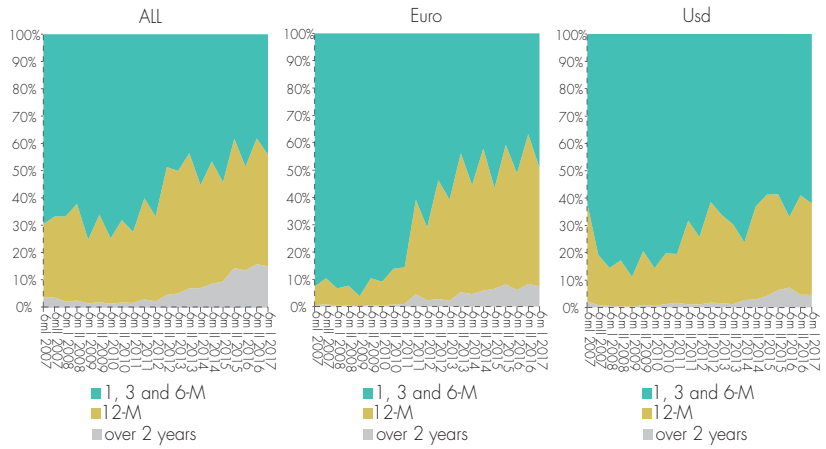
(82) The fall of deposits during the period is concentrated in the large banks group, G3. The narrowing of G3 deposits was higher than the total decrease of the sector's deposits base. This shows the slight increase of deposits (in aggregate) in the group of medium-sized and small banks. According to the

[51] *Since October 2013, while the annual growth of time deposits began to register negative rates, time deposits fell by 17.2%, whilst their share to total deposits decreased from 77% to 57.5%.*

Herfindahl index, the concentration of deposits stands below the moderate levels[52] (1,438 points), showing thus an appropriate concentration level.

(83) During the period, the flow of new time deposits in the banking sector was ALL 243 billion or about 26% lower compared to the previous six months. The share of new time deposits in the total of new deposits decreased down to 16% compared to 19% in the previous six-months and 21% compared with the first six-months of 2016. There was a slight shift of deposits to longer-term maturities within the structure of new time deposits. The inflow of new deposits in lek and euro fell by 13% and 12% respectively, while in US dollar it increase by over 15%. During the period, average interest rates of new time deposits in lek remained at 0.9% almost unchanged from the previous period, whilst the interest rates for new demand deposits in USD and Euro slightly decreased, at 0.2% and 0.3% respectively.

Chart 8.26 New time deposits by currency and maturity, 6-month flows.



Source: Bank of Albania, Financial Stability Department.

8.4.1 LIQUIDITY RISK

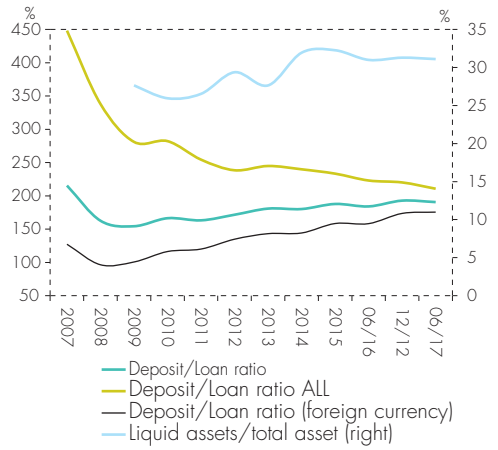
(84) Liquidity position of the banking sector stands at good levels. The liquidity ratios, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source of funding, by covering almost twice the volume of loans for the sector.

(85) The banking sector maintains a good liquidity position with a considerable outstanding client deposits to loans. In June 2017, the deposit-to-loans ratio stood at 190.6%. By currency, this ratio stands at 211% for the domestic currency and 176% for foreign currency.

[52] *Herfindahl's index values up to 1500 indicate a competitive market, values of 1500-2500 show moderate competitiveness, and values over 2500 a high concentration.*

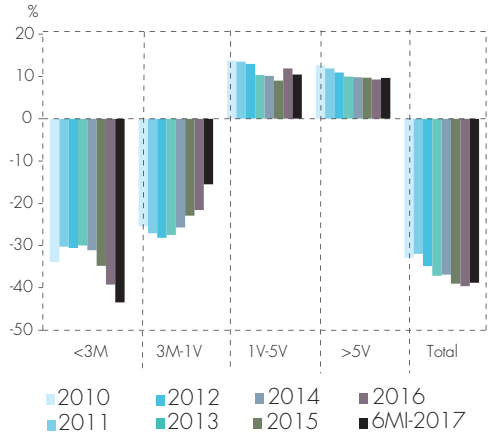
(86) Liquid assets in banks' balance sheets remain high, following the performance of lending below potential. At the end of June 2017, liquid assets accounted for 31.1% of total assets of the banking sector, slightly downward by 0.2 p.p. during the period. The other liquidity indicator, "liquid assets/ total short-term liabilities" increased slightly by 0.5 p.p, at 41.1%. Although banks are operating under ample liquidity, the mismatch between assets and liabilities, by residual maturity segments, against total assets, is considered as high and upward from the previous periods, in the short run.

Chart 8.27 Liquidity indicators



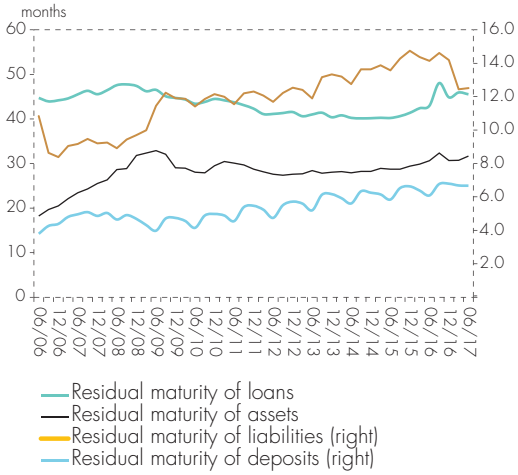
Source: Bank of Albania, Financial Stability Department.

Chart 8.28 Assets and liabilities maturity mismatch*



*Off balance sheet items (assets and liabilities) are also included.
Source: Bank of Albania, Financial Stability Department.

Chart 8.29 Average remaining maturity



Source: Bank of Albania, Financial Stability Department.

(87) The mismatch between medium-term assets and liabilities, increased during the period. It was estimated at around 19.1 months in June 2017, from 16.5 months at the end of 2016, representing the highest value since 2010. The remaining maturity of deposits, as the most representative item of liabilities, narrowed slightly to 6.7 months during the period. The residual maturity for credit, on the assets side, expanded to 45.5 months, from 44.8 months in December 2016, reflecting the banks propensity to grant credit for longer-term periods.

(88) The value of financing lines by parent bank groups has a very low share in the banking sector's financing sources. During the period, the total value of these lines was ALL 8.7 billion, compared to ALL 6.3 billion at the end of 2016. For banks that have credit lines with the parent bank groups, at the end of the period, the level of their usage was 16.3%, from 29.6% in December 2016.

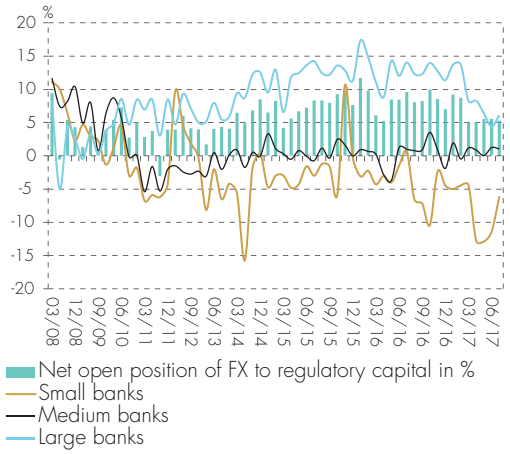
8.5 MARKET AND OPERATIONAL RISK

8.5.1 EXCHANGE RATE RISK

(89) **The banking sector's net open foreign currency position to regulatory capital ranged within long-term levels, pointing to a limited and downward exposure of the banking sector to the direct impact on the balance sheet, from the exchange rate volatility.** At the end of the period, the net open foreign currency position was "long" at 5.6% of the regulatory capital, being 1.5 p.p. lower than in December 2016, and 2.9 p.p. lower than a year earlier. As chart 8.30 shows, the performance of the banking sector indicator is driven mainly by the larger banks. The latter continue to maintain a "long" position at 4.4% of regulatory capital, but this position is considerably lower compared to 12% and 11.4%, recorded in the previous year and six–month period. The medium-sized banks increased their foreign currency exposure by 3.1 p.p. from the previous six months, and positioned "long" at 1.2% of the regulatory capital, but they did now show any change compared to the previous year. The small banks have expanded their "short" foreign currency position as compared to the previous six months and the previous year at 11.4% of the regulatory capital.

(90) **During the period, the banking sector's exposure to indirect foreign exchange risk remains at levels close to the latest values of 2016.** At the end of 2017, the foreign currency mismatch indicator[53] for all currencies stood at the same level of the previous six months, 18.4% of the assets. Contraction of foreign currency assets by 2.8% was offset by the decrease of foreign currency credit to resident entities followed by the contraction of foreign currency liabilities. Also, the contraction of total banking sector assets over the previous six months has contributed to maintaining the foreign exchange mismatch unchanged. Foreign currency mismatch in euro increased by 0.4 p.p. reaching 17.8%, while in US dollar it dropped by 0.5 p.p., at 0.8%.

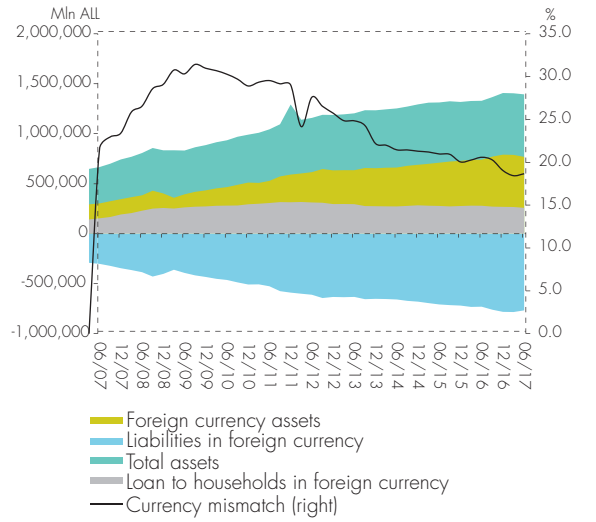
Chart 8.30 Open foreign currency position to the regulatory capital by peer group size



Source: Bank of Albania, Financial Stability Department.

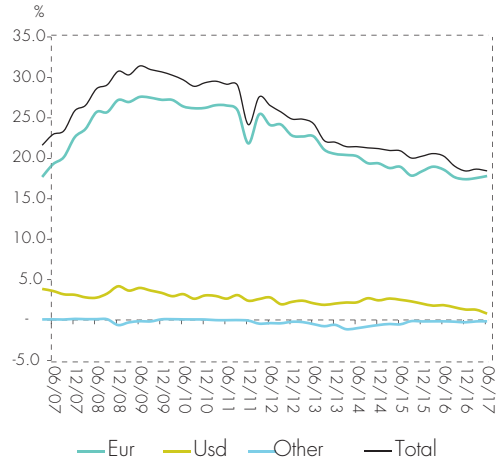
[53] *The foreign currency mismatch indicator measures the level of coverage of banking sector liabilities in foreign currency liabilities with foreign currency assets in net foreign currency resident credit. A low value of the ratio of this indicator to total assets shows a low exposure to exchange rate movements. For more detailed explanations of the foreign exchange mismatch, see the Financial Stability Report 2016 H1.*

Chart 8.31 Foreign currency mismatch by components



Source: Bank of Albania, Financial Stability Department.

Chart 8.32 Foreign currency mismatch by currency

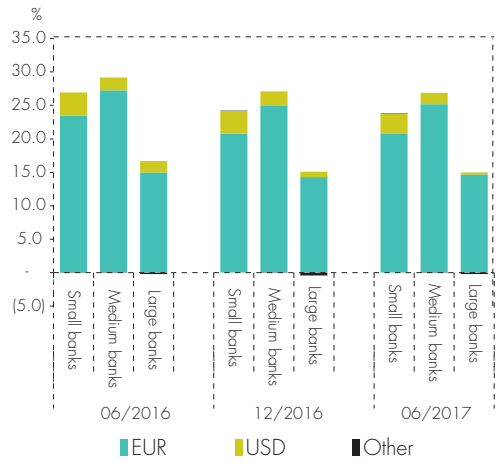


Source: Bank of Albania, Financial Stability Department.

(91) For all three banking groups, the exposure to indirect foreign exchange risk has not changed from the previous six months, but there is a downward trend compared with the previous year. Due to the fact that the foreign currency mismatch is related to the level of exposure to exchange rate indirect risk, the larger banks group has the lowest level of exposure or a higher rate of coverage of foreign currency liabilities with assets denominated in foreign currency, while medium-sized banks show higher exposure or lower coverage of foreign currency liabilities. For these groups, the foreign currency mismatch index at the end of 2017 H1 was 14.8% and 26.9%, respectively, while for small banks the index was 23.8%.

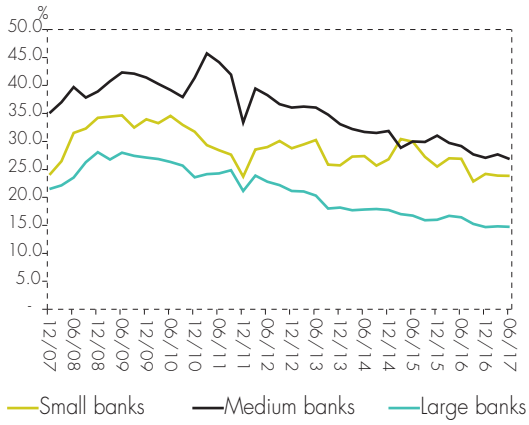
Chart 8.34 shows that in the last five years the exposure to indirect foreign exchange risk has been declining for the medium-sized and large banks, whilst small banks show volatility to this exposure.

Chart 8.33 Foreign currency mismatch by currency



Source: Bank of Albania, Financial Stability Department.

Chart 8.34 Foreign currency mismatch by groups

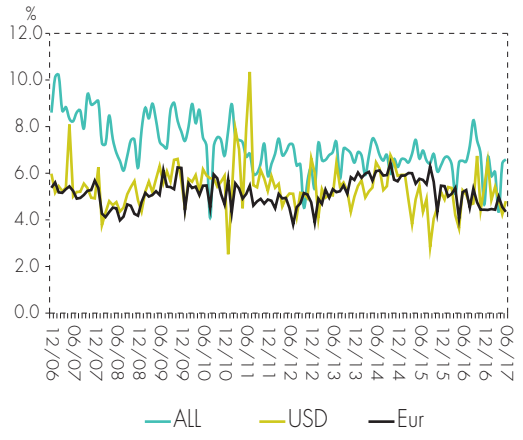


Source: Bank of Albania, Financial Stability Department.

8.5.2 INTEREST RATE RISK

(92) The banking sector remains exposed to interest rate volatility when the mismatch between interest rate-sensitive assets and liabilities, by repricing periods, is relatively high. During 2017 H1, the sector has reduced its exposure to interest rate volatility for the short-term period up to one month and up to 3months, narrowing the cumulative mismatch between interest rate-sensitive [54] assets and liabilities. Compared to 2016 H2, the mismatch between interest rate-sensitive assets and liabilities with up to 1-month maturity, decreased at 10.5% of the assets, from 13.4% in December 2016; whilst the mismatch for the remaining maturity up to 3 months, decreased at 7.2% of the assets, from 16.1% in December 2016. Meanwhile, the "assets - liabilities" mismatch for the remaining maturity up to 12 months expanded by 1.2 p.p., up to 10.2% of the assets of the banking sector. The decrease in the mismatch between interest rate-sensitive assets and liabilities reduces the risk that the banking sector and specific banks will face costs in case economic developments suggest an increase of interest rates in the market. The assessment of the risk that may arise from the interest rates fluctuations, in addition to monitoring the direct impact on the financial result of banks, (through impact on the net interest income and on revaluation income) should take into account the indirect impact from interest rate volatility on borrowers' solvency. A potential increase of the interest rate may affect negatively the borrowers' solvency and may be associated with problems in credit quality.

Chart 8.35 Interest rates spread by currency



Source: Bank of Albania, Financial Stability Department.

7.4.3. OPERATIONAL RISK

(93) The level of capital coverage for the operational risk of the banking sector is satisfactory and stable for the period. Capital requirements to cover operational losses stood at ALL 85.3 billion at the end of the period, same as at the end of 2016. The capital adequacy indicator was not affected by the fluctuation risk of operational losses for the period.

Chart 8.36 Capital requirement for operational risk

Source: Bank of Albania, Financial Stability Department.

[54] *Starting from December 2016 the off-balance sheet items are included in the interest rate –sensitive assets and liabilities.*

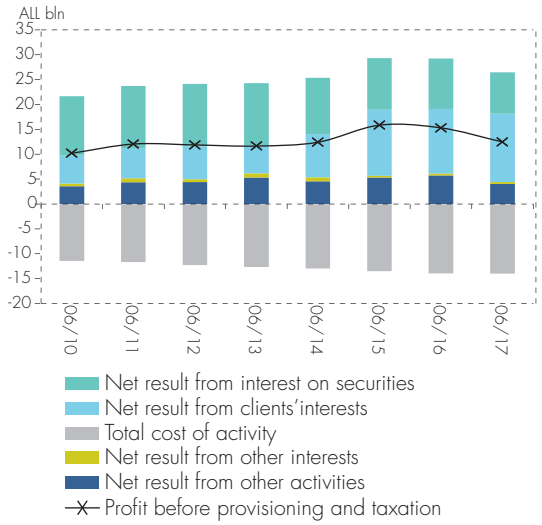
8.6 FINANCIAL RESULT AND EFFICIENCY OF FUNDS

(94) The banking sector reported a positive financial result, significantly upward compared to the previous year.

Due to the faster decline in interest income compared with the declining rate of financing costs, net interest income and net interest margin have declined. Other activities also fell, mainly from income from securities transactions and foreign currency transactions. The costs in the form of provisions for the credit risk, decreased considerably and represent the main factor contributing to the increase in banking sector profitability. This development is in line with the positive performance of the credit portfolio, where the significant decrease in the ratio of non-performing loans contributed to this result.

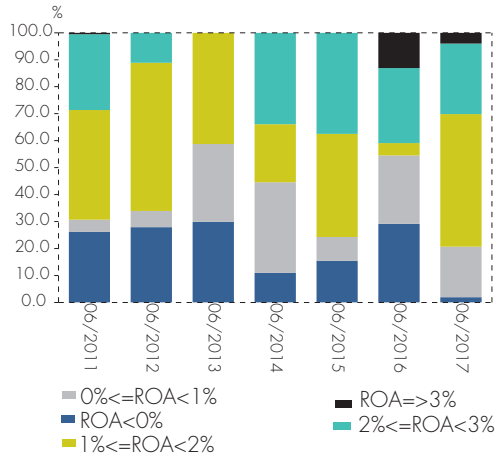
(95) At the end of the period, the banking sector reported a positive financial result of around ALL 11.5 billion or around ALL 6.4 billion higher compared with the previous year. The main profitability ratios , Return on Assets (RoA) and Return on Equity (RoE) resulted at 1.6% and 16.7%, standing 0.9 percentage point and 8.7 percentage points, respectively, higher than in the in the previous year. The small banks group is the only group, whose RoE and RoA declined.

Chart 8.37 Financial result components



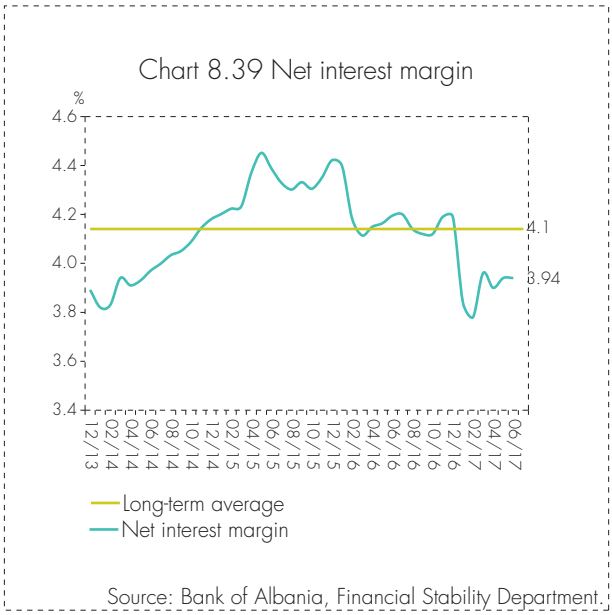
Source: Bank of Albania, Financial Stability Department.

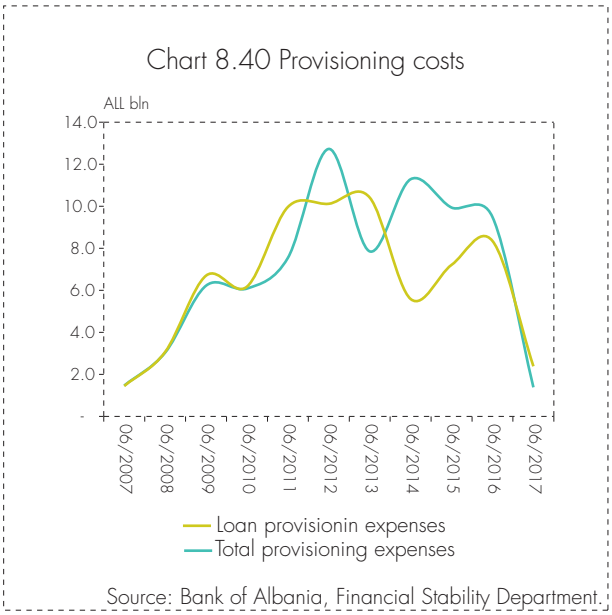
Chart 8.38 RoA by banks' share in the assets of the sector



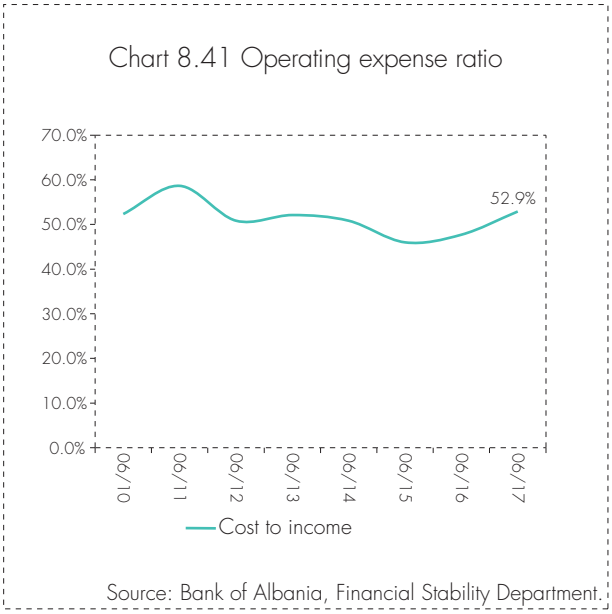
Source: Bank of Albania, Financial Stability Department.

(96) The continuous lowering of financing costs did not sufficiently offset the fall of income from the main banking activity. Thus, net interests result fell by around ALL 1.1 billion, at ALL 22.4 billion, since the decrease in income from interests resulted higher than the decrease of expenses for interests. As a result, the net interest margin also declined to 3.9%, from 4.2% in the previous year.





(97) Provisioning costs recorded ALL 1.4 billion, or ALL 8.1 billion lower than a year earlier, representing the main factor driving to the growth of the after the sector's financial result. Loan provisioning costs fell by ALL 6 billion. For individual banks, given that the net result from the banking activity has not shown significant changes or recorded a decline, the decrease in provisioning costs provided the main impact in the increase of the financial result. The share of banking banks' assets in the banking sector's assets of that recorded a financial loss fell considerably to 2%; practically only 3 small banks reported financial losses, with very low values.



(98) The financial result from other activities fell by about ALL 1.7 billion, as a result of the decline in income from transactions with securities and foreign currencies. At the same time, the activity costs, even though slightly up, were covered adequately by the activity income, thus providing a positive impact on gross operational income (before provisioning). The operating expense ratio was 52.9% and shows a low volatility in recent years.

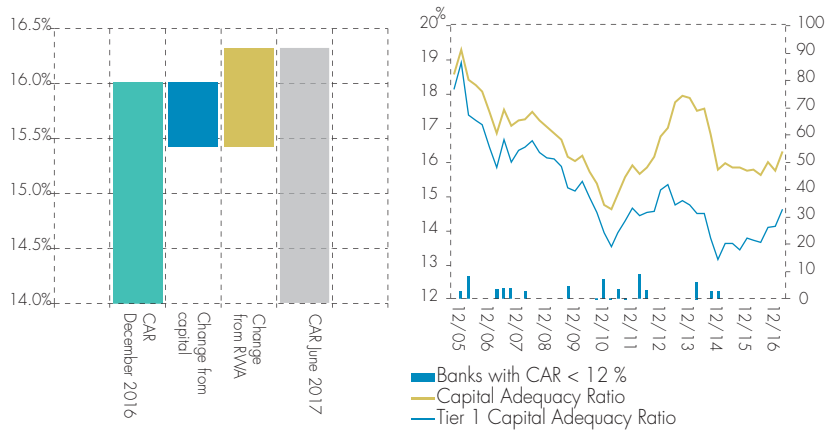
8.7 ACTIVITY CAPITALISATION

(99) The banking sector's capitalization in June 2017 was estimated to be satisfactory, and its performance was determined by the sharp contraction of capital requirements for investments in non-resident entities. Regulatory capital marked a decline despite the capital injection and a positive financial

result, affected by the reduction of subordinated debt and other capital items. On the other hand, the faster contraction of risk-weighted assets due to the decline of risk-bearing assets for investments in non-resident entities has contributed to the maintenance of a high level of capital adequacy ratio. This level is significantly above the minimum regulatory rate allowed for individual banks and the banking sector as a whole.

(100) In June 2017, the capital adequacy ratio stood at 16.3%, from 16.0% as at end- 2016, and 15.8% a year earlier. In 2017 H1, risk-weighted assets were 5.3% lower compared with December 2016, contributing to the increase in the capital adequacy ratio by 0.9 pp. On the other hand, due to the reduction of subordinated debt and other capital items (revaluation differences), regulatory capital fell by 3.5%, contributing to the decline of the capital adequacy ratio by 0.6 percentage points.

Chart 8.42 Capital adequacy ratio

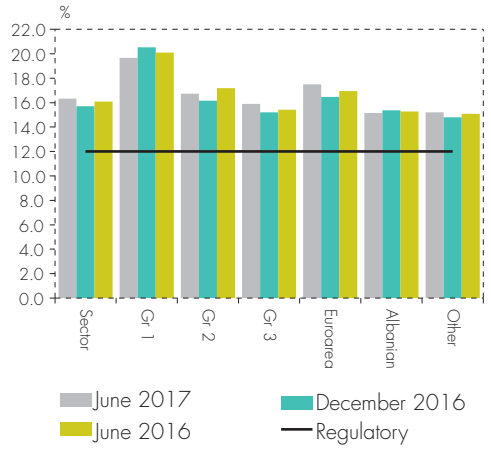


Source: Bank of Albania, Financial Stability Department.

(101) At peer group level, G3 banks have the lowest average capitalisation rate, whilst by capital origin, appears banks classified as "Other"[55] and banks with Albanian capital. For the most part, individual banks maintained capital adequacy ratios in the range of 14% - 18%. However, in the first six months of the year, the adequacy ratio of three banks of the banking sector ranged 18% - 20%.

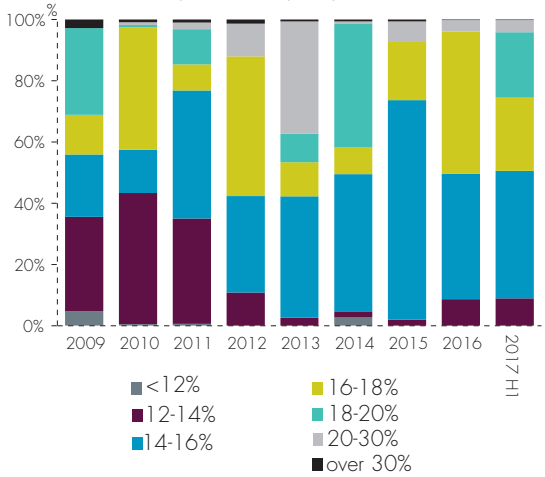
[55] *This group includes banks of Turkish, Arabian, Kuwaiti and Malaysian capital.*

Chart 8.43 Capital adequacy ratio by group, size and origin of capital



Source: Bank of Albania, Financial Stability Department.

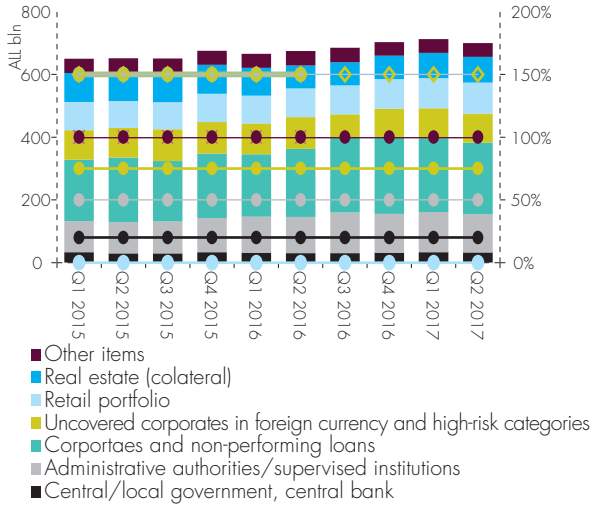
Chart 8.44 Asset allocation of banking sector, by Capital Adequacy Ratio



Source: Bank of Albania, Financial Stability Department.

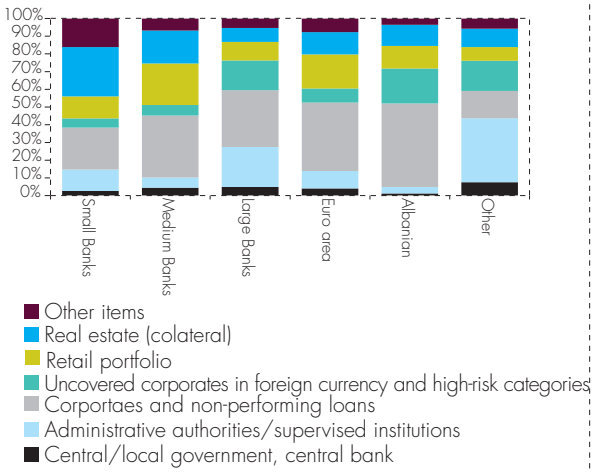
(102) The Banking sector shows a decreasing exposure in terms of credit risk classes. Assets weighted for credit risk reduced by around ALL 1.9 billion, compared to the end of 2016, down to ALL 700 billion. Credit categories that decreased are related to exposures to corporates and non-performing loans which have a 100% risk coefficient (Chart 8.45). By peer bank groups, small banks represent a high exposure to credit collateralised in the form of real estate; medium-sized banks have a higher exposure to credit to corporations and non-performing loans; meanwhile, large banks, besides these categories, remain exposed to lending to managing bodies and supervised institutions. By capital origin, it is noted that banks with Albanian capital have a higher exposure to the class "Credit to corporations and Non-performing loans" (Chart 8.46).

Chart 8.45 Risk-weighted coefficients and size of main credit portfolio classes



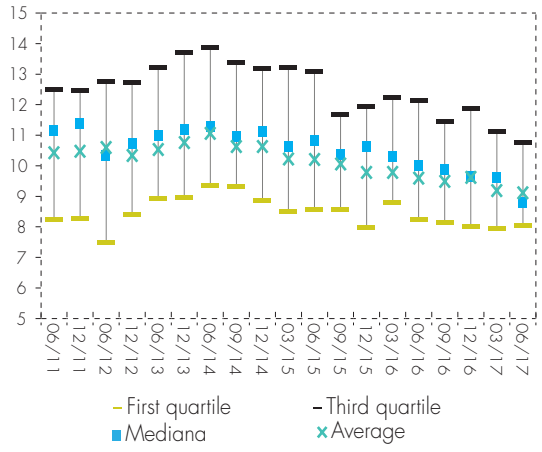
Source: Bank of Albania, Financial Stability Department.

Chart 8.46 Classes of credit exposures for banks by business size and capital origin for June 2017



Source: Bank of Albania, Financial Stability Department.

Chart 8.47 Financial leverage ratio, through the years



Source: Bank of Albania, Financial Stability Department.

(103) Capital requirements for market risk decreased, while those for operational risk remained unchanged during 2017 H1. During the period, capital requirements for market risk registered ALL 14.5 billion, down by ALL 0.6 billion or 4.1%. Capital requirements for operational risk remained unchanged. The latter account for approximately 10.1% of total risk-weighted assets, while capital requirements for market risk account only 1.7%.

(104) The Albanian banking sector is characterized by a low financial leverage ratio, which confirms the maintenance of a good level of capitalization. As of end-June 2017[56], the financial leverage ratio was 10.1, from 10.4 a year earlier. The financial leverage at individual banks level does not show any significant shift.

[56] *The financial leverage is measured as the ratio of assets to equity.*

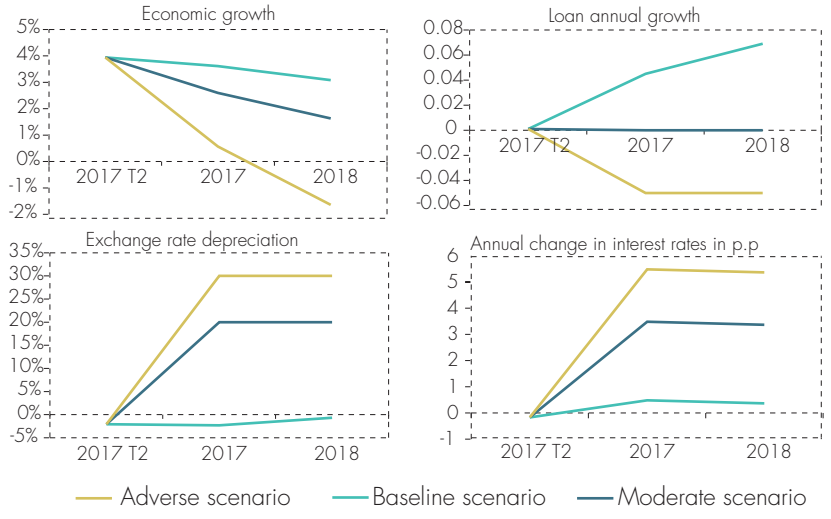
9. ASSESSING BANKING SECTOR RESILIANCE THROUGH STRESS-TESTING[56]

(105) Stress testing assessed the banking sector resilience against economic and financial developments two years ahead. Although the results show that the banking sector remains stable, it appears to be more exposed in the case of the adverse scenario, in which the assumptions are also more extreme. *In terms of capital adequacy, the impact of such scenarios evidences the need for additional capital in some of the individual banks. The stress test on the liquidity situation corroborates the assessment for a strong liquidity position in the banking sector.*

9.1 ASSESING THE RESILIENCE TO MACROECONOMIC SHOCKS

(106) The stress test exercise assesses the banking sector's resilience and capital adequacy for the period 2017-2018. The assessment of the impact from macroeconomic situations on the financial situation of the banking sector excludes the possibility of increasing the paid-in capital during the period, and is performed by applying three scenarios: baseline scenario, moderate scenario and adverse scenario. The last two scenarios have a lower probability of occurrence.

Chart 9.1 Assumptions to construct the stress test



Source: Bank of Albania, Financial Stability Department.

[57] *Stress-testing is not a forecasting method. Intentionally, the scenarios contain adverse and extreme developments, but with a low probability of occurrence to test the banking sector resilience. Though banks are encouraged to assess their financial situation to withstand effects from these scenarios, they should not regard them as events the Bank of Albania expects to take place in the future. The scenarios vary over time, depending on the economic and financial developments. In addition, the scenarios do not take into consideration operations that banks and authorities may carry out to constantly strengthen their financial position and resilience to risks.*

(107) The baseline scenario assumes a positive economic growth until the end of 2018, and relatively comparable with the factual values of 2017 Q1. In this scenario, the economic growth is accompanied with stable lending, supported by significantly improved credit portfolio quality until the end of 2018. The portfolio of non-performing loans continued to be significantly affected by the measures taken by the Bank of Albania in the framework of treating non-performing loans.

(108) The moderate scenario assumes a positive economic growth, but at a slower pace than the baseline scenario, while the adverse scenario assumes a contraction of the economy until the end of 2018. These developments, coupled with a depreciation of the exchange rate, increase of interest rates and shortage and/or contraction of lending, affect the banking sector's performance in terms of its capitalisation. The credit portfolio quality for these scenarios reflects, in addition to cleaning the balance sheets, the new flows in non-performing loans. As a result, until the end of 2018, the ratio of non-performing loans is presented as worsened up to 17.5 p.p. in the moderate scenario and up to 36.5 p.p. in the adverse scenario against the baseline scenario level. The adverse scenarios, in addition to the reduction of credit quality, assume also shocks in terms of market risk: the interest rate risk, re-pricing securities risk, exchange rate risk, and operational risk.

(109) Stress test results in terms of capital adequacy show that:

a. - in the baseline scenario, the capital adequacy ratio (CAR) of the sector registers 16.1% at end- 2017, and 16.6% at end- 2018, following the faster credit growth and the improvement of credit quality, as well as the more favourable performance of the exchange rate. Developments by banking groups attest to resilience and capitalisation above the regulatory minimum requirement.

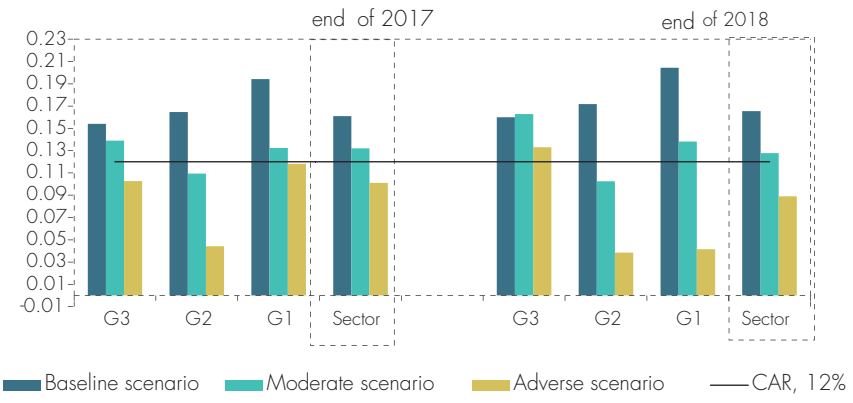
b. - in the moderate scenario, the sector's CAR reaches 13.2% at end-2017 and 12.8% at end- 2018. This rate is driven by assumptions for a lower growth rate of economic activity; shortage of lending to the economy; increase in interest rates; and, depreciation of the national currency. Despite maintaining the capitalisation level at sector level, the developments in individual banks evidence the need for capital injection in six of them, which account for about 35% of the sector's assets. In this case, the needs for additional capital amount up to ALL 15.2 billion until the end of 2018;

c. - in the adverse scenario, the sector's CAR drops even further to 10.1% at the end of 2018, based on even more adverse assumptions included in the scenario. In this scenario, ten banks fall below the required capitalisation level; they account for about half of the sector's assets. The extreme macroeconomic developments that the scenario contains, contribute to the deterioration of credit quality, in the level of

losses of the securities portfolio and the increase of exposure to market and operational risk. In this case, the needs for additional capital are significantly higher than in the moderate scenario.

In a real context, during the period, the paid-in capital of the banking sector increased by around ALL 5 billion or two times higher than the capital growth in same period of the previous year.

Chart 9.2 Capital adequacy ratio, by stress test scenarios



Source: Bank of Albania, Financial Stability Department.

9.2 LIQUIDITY STRESS TEST

(110) **The purpose of the liquidity stress test is to assess the ability of individual banks and of the banking sector to withstand extreme but potential shocks to their financing activity.** These tests aim to identify weaknesses or deficiencies of the sector and particular banks in currencies, instruments and certain time horizons; to assess banks' readiness to cope with extreme liquidity shortages; and to help the supervisory authority to undertake specific policies that address liquidity management, including measures aimed at reducing exposures or creating specific reserves.

(111) **The analysis, in this case, is built based on the liquidity structure of the sector in May 2017.** The information is taken by individual banks data, for granular money flows generated by assets and liabilities classified by maturity structure. The various scenarios assume some shocks from the unexpected deposits withdrawal and assess the adequacy of expanded liquid assets available for financing them. More specifically:

(i) The test assumes the banks will be able to cope with a pronounced deposit withdrawal, only through the sale of expanded liquid assets (without asking for additional liquidity from the Bank of Albania);
(ii) Investments in securities are sold through a haircut of their value by 10% and 20%. The bank is considered as failing the stress test only if expanded liquid assets shrink to the level when additional liquidity is needed by the Bank of Albania in the form of "loan for liquidity support".

Banks fail the stress test only if the expanded liquid assets[58] which are sold at haircut margins set by the test, are insufficient and there is an additional need for liquidity by the Bank of Albania in the form of a "liquidity support loan".

(112) The test results show that overall the banking sector passes the liquidity stress test successfully. The scenario which assumes the use of enhanced liquid assets for closing the gap, shows that for the Albanian lek, there is 1 bank which is not able to close the gap for 6 of 8 maturity baskets and there are 2 banks which are not able to close the gap for 1 of the maturities; For the euro, the gap continues to be negative for 2 banks for first two maturity baskets, whilst for the US dollar the gap remains negative for 1 bank for all the baskets beyond the first basket (up to 1 day).

(113) The test results show that the banking sector successfully passes the liquidity stress test. In comparison with the last six-months, the results for the liquidity gap[59] show a weakening of the situation for euro and US dollar and an almost similar situation for the Albanian lek.

(114) Compared to the previous six months, considering the number of banks that fail the stress test, there is an improvement for the lek and US dollar, and an unchanged situation for euro. Regarding lek, the maximum number of banks that fail to close the negative liquidity gap even after the sale of expanded liquid assets is 2 and lower compared to 3-4 banks that continued to have a negative gap in the stress test of the last six-months, which reflects an increase in the stock of liquid assets in lek. After the sale of liquid assets, for the other two currencies, the system is left with only 1 bank that continue to register a negative gap in the respective currency. For all three currencies, the gap size for the baskets with the largest gap in relation to the sector's assets in that currency is quite low (0.2% for lek, 0.3% for euro and 0.4% for US dollar) The test shows that there are no banks in the banking sector that are facing liquidity difficulties in two or three currencies at the same time, and that banking sector has strengthened the counterbalancing capacities compared to the previous six months.

[58] *Unlike the concept of liquid assets according to the regulation of the Bank of Albania, which limits the maturity of the securities that are considered as liquid assets, in this concept for purposes of this test, is included the entire portfolio of securities.*
[59] *Before selling liquid assets.*

(115) In conclusion, banks are assessed to have a high resilience to liquidity shocks. However, the low diversification level of liquidity reserves, which consist mostly in government debt securities, evidences the need for deepening the market and increasing liquidity for these instruments.